

IN THE DISTRICT COURT OF THE UNITED STATES
DISTRICT OF SOUTH CAROLINA
CHARLESTON DIVISION

ROBERT J. NAGY,) 2:08-CV-2555
)
Plaintiff) Charleston,
) South Carolina
VS) June 29, 2010
)
UNITED STATES OF AMERICA,) VOLUME VI
)
Defendant)

TRANSCRIPT OF JURY TRIAL
BEFORE THE HONORABLE DAVID C. NORTON,
CHIEF UNITED STATES DISTRICT JUDGE

APPEARANCES:

For the Defendant: MR. NATHAN CLUKEY
MR. GREGORY SEADOR
MS. ELLEN WEIS
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Proceedings recorded by mechanical shorthand,
Transcript produced by computer-aided transcription.

1 THE COURT: Okay. I'm ready when y'all are.

2 MR. CLUKEY: We've got a number of issues we would
3 like to address.

4 First of all, the parties have just discussed
5 regarding the total number of transactions upon which the
6 penalties would be based, and we are willing to recommend
7 stipulating -- the Government is going to have to go up to my
8 boss to approve this, it's going to have an impact on the
9 total number of -- the total amount of penalties -- but we
10 are willing to recommend -- we would stipulate to the number
11 that -- Mr. Nagy calculated and prepared a summary chart, and
12 we would be willing to stipulate, just for purposes of this
13 case only, to the total number of transactions, which would
14 obviate having to have the jury decide, weigh our chart that
15 we did, and the IRS chart.

16 THE COURT: And everybody is on pins and needles
17 about what the number is. What's the number?

18 MR. CLUKEY: The number is actually broken up by
19 year, so --

20 THE COURT: Are you stipulating per year or are you
21 stipulating in total, or what are you doing?

22 MR. CLUKEY: Stipulate by year and do the
23 calculations to get the total number, I think it's 2387 total
24 number of transactions.

25 THE COURT: You and Mr. Cooper have agreed on a

1 number, but it has to be approved in Washington?

2 MR. CLUKEY: Correct.

3 THE COURT: And will it be approved in Washington
4 prior to the time we have to get it to the jury?

5 MR. CLUKEY: We actually teed this up with
6 Washington yesterday. So hopefully, we'll get things moving
7 as fast as we can.

8 THE COURT: So what happens if we don't get word
9 back from Washington, assuming we get to the jury and they
10 find liability?

11 MR. CLUKEY: We are going to make -- move it as fast
12 as possible. I can't promise you anything, but I'm going to
13 try.

14 THE COURT: Sometimes it's like pushing a chain, it
15 can't be done.

16 MR. CLUKEY: Things are in motion.

17 THE COURT: You agree with that, Mr. Cooper?

18 MR. COOPER: Yes, Your Honor.

19 MR. CLUKEY: So just for clarification, there is
20 also a total of FRN transactions. Mr. Nagy says he's not
21 liable for FRN transactions. We'll stipulate to the number
22 of FRN transactions. Mr. Nagy is not stipulating to
23 liability of any of these numbers. This doesn't pertain to
24 the conduct after October 2004 when the Statute changes, so
25 we've got evidence of the total that we think Mr. Nagy

1 earned, but I think Mr. Nagy still, there is evidence about
2 what he earned after 2004, if I understand things correctly.

3 MR. COOPER: That's correct.

4 THE COURT: All right. What else?

5 MR. CLUKEY: Okay. Secondly, there was -- we had
6 one issue with the Socks deposition. I think this is a
7 single --

8 MS. WEIS: I can hand it to the Court, but it's
9 pages 66 to 67. You had overruled the objections we had for
10 calling her testimony under the law and --

11 THE COURT: Okay. Let me see. Okay.

12 MR. COOPER: Your Honor, I haven't seen that yet.
13 If you've already made your rulings -- thank you.

14 MS. WEIS: Your Honor, this is an issue that we
15 believe will also come up with Ms. Gadsden that these are --
16 they are being called as fact witnesses. They couldn't be
17 called as witnesses on the law. And the questions that Ms.
18 Socks are asked in the deposition on pages 66 and 67 are on
19 the legal effect of whether or not the IRS can allow or
20 disallow certain deductions and the consequences with that
21 for the 90% program. And she's basically being asked to
22 speculate on a law.

23 So we would say that that would be improper
24 testimony, both from Ms. Socks, via her deposition, and also
25 from Ms. Gadsden.

1 And on that issue actually, Your Honor, we want
2 to -- I have relayed a note -- just so Your Honor is aware,
3 Ms. Gadsden is here today and will be testifying. We believe
4 Mr. Nagy is going to call her.

5 And the way that it works with IRS agents, they have
6 to get authorization from the IRS to be able to testify. We
7 believe that the testimony that she's been -- the scope of
8 that testimony is broad enough that we won't encounter any
9 problems. And she's been told that if Your Honor says she
10 needs to testify about something, she will. One of the
11 things --

12 THE COURT: You -- I couldn't hear what you just
13 said.

14 MS. WEIS: Sure.

15 So in her authorization, which is required, the IRS
16 has to sort of create a testimony authorization for Ms.
17 Gadsden.

18 One of the issues that she's not allowed to testify
19 about, unless Your Honor, of course, you know, overrules
20 that, is questions on the law. She's being called here to
21 testify as a fact witness about things that she personally
22 observed, and it's just not a judge or an attorney or anyone
23 that could offer testimony on the law.

24 So as to Ms. Gadsden, and also to Ms. Socks and the
25 testimony that we just identified, we believe that that

1 should be excluded.

2 THE COURT: Okay. Let's go back just to square one.

3 If Ms. Gadsden is going to be here, you can't read a
4 deposition and have her here.

5 MS. WEIS: No, Your Honor. Ms. Socks's deposition
6 testimony will be read. Ms. Gadsden is here.

7 THE COURT: Okay.

8 All right. What you say, Mr. Cooper?

9 MR. COOPER: Well, starting with Ms. Gadsden, the
10 fact is she allowed the interest expense deduction, that's a
11 fact, and that fact was communicated to Mr. Nagy. And the
12 simple basis is you have to allow it if there is a bona fide
13 loan. And that's all she's going to say.

14 As a revenue agent, she allowed the interest expense
15 deduction because it was a bona fide loan, and that was
16 communicated to Mr. Nagy. And that's her exact words in the
17 deposition. And we believe the jury has to understand that
18 as to what the actual IRS agent did and what that
19 communicated to Mr. Nagy for them to understand Mr. Nagy's
20 state of mind.

21 The same is true with Ms. Socks. She has special
22 training in tax law. And as I pointed out, the simple
23 question, can you allow interest expense if it's not a bona
24 fide loan, the answer is no. So we don't think it's law,
25 it's the fact that it can't be allowed unless it's a bona

1 fide loan.

2 MS. WEIS: Your Honor, we would say that's a fact of
3 a legal conclusion.

4 Ms. Gadsden also testified in her deposition that
5 she did not have the expertise to make that determination,
6 and, in fact, did not make the determination that Mr. Cooper
7 just referenced, that, you know, this was going to be
8 accepted as a bona fide loan.

9 In fact, Ms. Socks and Ms. Gadsden are very
10 consistent in their testimony during their, both of their
11 depositions, that nobody made an ultimate conclusion as to
12 whether or not this was a loan or a sale, and that nobody
13 communicated that act, communicated that such a determination
14 had been made to Mr. Nagy.

15 So that's getting into both the motion in limine,
16 and our main objection to Ms. Socks's testimony is that it is
17 calling for a legal conclusion and it is improper testimony
18 under the law.

19 THE COURT: Now --

20 MR. COOPER: Your Honor, I mean, she testified
21 specifically that she accepted it as a bona fide loan -- and
22 I'm looking for the deposition testimony -- and because she
23 accepted it, that's why she issued the no change with no
24 changes. And she also testified by doing that, she
25 communicated that the loan was accepted at that time.

1 I mean, those are very relevant facts to Mr. Nagy's
2 state of mind.

3 MR. CLUKEY: At the same time she testified that,
4 Your Honor, I, of course, objected that it was calling for a
5 legal conclusion. That actually precedes her answer.

6 And she did repeatedly testify throughout the
7 deposition she lacked the expertise to make any determination
8 of whether this was a bona fide loan or sale. And that's the
9 reason why she referred this to Mary Socks.

10 And the reason why she referred it to an
11 international examiner, it's just that she's a -- she just
12 doesn't have that expertise. And it's clearly -- Mr.
13 Cooper's clearly trying to get her legal conclusion, A, what
14 he thinks he's calling a conclusion into evidence and have
15 her testify as an expert on law.

16 MR. COOPER: Your Honor, the question is:

17 "Question. So there was a no change -- so -- so did
18 you have -- that time you issued a no-change letter, it was
19 communicated that it was a bona fide loan for which an
20 interest expense could be taken, correct."

21 "Objection to form foundation."

22 "Witness. At the time it was accepted as a bona
23 fide loan."

24 And if that is the whole basis of Mr. Nagy's belief,
25 is that when she issued that no change, everyone knows that

1 that revenue agent has to accept that position in order to
2 make no changes. And that's exactly what it communicated to
3 Mr. Nagy.

4 And the revenue agents want to confirm that, Mr.
5 Nagy has already testified to it, but the revenue agent, in
6 her belief is what happened and what was communicated at that
7 time.

8 THE COURT: Who issued the no change?

9 MR. COOPER: She issued --

10 THE COURT: She, who?

11 MR. COOPER: I'm sorry. Ms. Gadsden.

12 THE COURT: Okay.

13 MR. COOPER: She issued something called a revenue
14 agent report, which is Exhibit 37. And that has -- it's a
15 report that has line items in it about any changes that are
16 going to be made to that tax return.

17 Her report has no changes in it, and it's written at
18 the top: "Subject to approval by the area director."

19 And ultimately in Exhibit 38, their area director
20 issued the no change because that's -- he was just talking
21 about the -- the pyramid of command, that the area director
22 is the one that has to issue the no change in order for it to
23 be legally binding.

24 THE COURT: You mean legal and not binding?

25 MR. COOPER: Well, but --

1 THE COURT: I mean, I understand your argument, but
2 there is no evidence. I mean, there is nothing that's going
3 to be in the record that says a no change is binding.

4 MR. COOPER: Binding?

5 THE COURT: Binding.

6 MR. COOPER: No. I'm not saying it's binding.

7 THE COURT: That's what you just -- you just said
8 pyramid in command is -- the area director is the one to
9 issue the no change in order for it to be legally binding.
10 Those are your words.

11 MR. COOPER: To be procedurally correct, it has to
12 come out of the area.

13 THE COURT: All right.

14 MR. COOPER: But you know, the fact of the no change
15 and what it communicated and why it was communicated is
16 paramount to Mr. Nagy's state of mind. Because anyone that
17 practices before the IRS knows when that no change is issued,
18 those tax positions in the return have been accepted.

19 And as we saw, Scott Cathcart's return took an
20 interest investment interest deduction on the loans. And the
21 jury is -- needs to hear that from Ms. Gadsden, too.

22 MR. CLUKEY: Your Honor, I think Mr. Cooper just
23 nailed it. It's what was communicated, actually
24 communicated, and this Court's already ruled on that.

25 Ms. Gadsden did not communicate to Mr. Nagy, I'm

1 accepting this loan and I'm accepting this interest
2 deduction; therefore, it's a bona fide loan; therefore, that
3 never happened.

4 This is all information that Mr. Cooper was asking
5 about in 2009 in the deposition. And he's asking for her
6 opinion about the law and what that -- what that meant. That
7 was not communicated. This Court's already ruled that the --
8 in a motion in limine, the information that wasn't
9 communicated, that's not coming in. So Mr. Cooper is trying
10 to back door the --

11 THE COURT: It's not communicated, it's not coming
12 in. If the no change was communicated, I'll let it in.

13 MR. COOPER: But she is testifying as to what that
14 no change communicated. I mean, you can't take it --

15 THE COURT: She can't testify to what that no change
16 communicated. It means different things to different people.
17 Mr. Nagy indicated what the no change meant to him. It's his
18 state of mind.

19 MR. COOPER: I mean, how is it not important with
20 what the IRS we believed was communicating to Mr. Nagy? I
21 mean --

22 THE COURT: I already ruled, and you can take me to
23 Richmond, because I just got back yesterday and there is a
24 lot of courtrooms up there, okay? You can take it up, but it
25 doesn't make any difference.

1 Mr. Nagy's -- Mr. Nagy's state of mind, what the IRS
2 did is not binding. I mean, there is hundreds -- the cases
3 that I've been given, there is -- it's irrelevant what
4 happened in the internal workings of the IRS, if anyone can
5 define what happens over there, unless it was communicated to
6 Mr. Nagy.

7 MR. COOPER: But Your Honor, I mean, the issuance of
8 that no-change letter is what was communicated.

9 THE COURT: I understand, and that's already in
10 evidence.

11 MR. COOPER: But it's coming from an admission from
12 a party opponent on what was communicated. She -- she was
13 lead agent on the exam.

14 THE COURT: I'll listen to you all morning, but my
15 ruling is still going to be the same.

16 MR. COOPER: I -- okay. I just don't understand how
17 to -- for Mr. Nagy's state of mind, to accept that in a
18 vacuum of what the industry practice is before the IRS.

19 THE COURT: I understand what you are trying to do,
20 okay? And I understand what you have been trying to do
21 since -- for the last six months. And I'll put, chalk it up
22 to a good try. It's not coming in. And I really don't know
23 what your expert is going to testify to after reading his
24 report.

25 MR. COOPER: Well, the expert will be on two things.

1 One, he can talk about from his experience how
2 in-depth the review was.

3 THE COURT: What difference does it make? Tell me
4 what difference the review makes? What relevance that has to
5 this case?

6 MR. COOPER: It has relevance because it's not some
7 cursory review. I mean, this was an in-depth audit. He's
8 going to say in the 30 years he was at the IRS, he's seen a
9 handful of times where you've had this amount of specialists
10 involved in an exam, and this amount of in-depth review. So
11 it adds substance to what happened during the audit.

12 THE COURT: But did Mr. Nagy know that at the time
13 that he got the letter? Did he know any of that at the time
14 he got the letter? I mean, all he got was a no-change
15 letter. And in his experience, it's not an irrational
16 position to take, that that's a good deal. I mean, did he
17 know that there were -- he knew that he got some -- some
18 document requests from a couple of people, right? Ms. Socks,
19 and he already testified about all that, right?

20 MR. COOPER: Yes, he did.

21 THE COURT: So I mean, what difference does it make?

22 MR. COOPER: It makes a difference to his state of
23 mind. This is not an everyday audit. It's not as if I sat
24 down with a revenue agent for a half a day and picked out a
25 couple of line items on a tax return and close it within a

1 week. This went on for 18 months. There was an agent that
2 had a CPA's license. There were two specialists looking at
3 it. I mean, it was a substantial review. And someone that's
4 been in the IRS for 30 years should be able to communicate
5 that to the jury because it's not, you know, some back of the
6 envelope determination on what was going on.

7 And secondly, as an expert under, I believe it's
8 704(b), he's allowed to testify as to what import the
9 conclusion of the audit had on Mr. Nagy's state of mind.

10 THE COURT: Oh, no.

11 MR. CLUKEY: Your Honor, as to the first point -- I
12 think we are in agreement with Your Honor on the second
13 point.

14 As to the first point, Mr. Nagy's already testified
15 as to what he believed, whether or not he believed this was
16 an in-depth or a cursory audit. He's already testified to
17 that. Ms. Gadsden is going to get up here and testify, he
18 can certainly ask her about that, she's a fact witness.

19 Mr. Altemose, as you just touched on, Your Honor,
20 didn't communicate any of his views to Mr. Nagy at the time.
21 So whatever his views are about the in-depth, whether the
22 audit was in-depth or not, clearly has no bearing on Mr.
23 Nagy's state of mind.

24 THE COURT: 704(b), which you just cited, doesn't
25 even come close to saying what you think it says.

1 MR. COOPER: I'm sorry, 704(a).

2 In the case law that we cited in our -- in our
3 opposition to the motion in limine on Mr. Altemose was
4 *Bouygues Telecom S.A. vs. Tekelec* 472 F.Supp. 2d, 722,
5 Eastern District of North Carolina, as well as *U.S. vs.*
6 *Winfelder*, 790 F.2d 576 on page 580, the Seventh Circuit.

7 Those cases say in a civil case that an expert may
8 testify to the ultimate issue. And in all the cases, the
9 exception that 704(a) says is, you can't do it in 704(b),
10 that is -- the cases they cited, they are all criminal cases.

11 In a civil case --

12 THE COURT: That's because -- you cited a criminal
13 case, United States versus somebody.

14 MR. COOPER: No, Your Honor, it was a civil case.

15 THE COURT: Okay.

16 MR. COOPER: It was talking about a civil case.

17 THE COURT: Okay.

18 MR. COOPER: So we believe that Mr. Altemose in the
19 industry practice can come in and say at the conclusion of
20 the audit, what was Mr. Nagy's perception as to the
21 transaction?

22 THE COURT: You might put him up as a proffer. And
23 if I'm wrong, then the Fourth Circuit will reverse me.

24 MR. COOPER: I mean, I would just respectfully
25 request that at lunch we take a look at the cases, because I

1 mean, we are talking about what's being communicated to my
2 client by the IRS.

3 THE COURT: I understand that. That's all coming
4 in. What's being communicated to your client by the IRS, all
5 those document requests and all of that kind of stuff, that's
6 already in, isn't it?

7 MR. COOPER: It is.

8 THE COURT: Okay.

9 MR. COOPER: But the conclusion of the audit, that
10 that event happening, what does that communicate in the
11 industry practice? It communicates that the conduct and the
12 positions you have taken on your tax returns are okay because
13 there is no change.

14 THE COURT: What do you mean by lunchtime? I
15 thought we were going to be through by lunchtime, but I guess
16 we are not.

17 MR. COOPER: Well, with Ms. Gadsden, and reading it
18 in. I would just -- because this is highly important. I
19 mean, these are our three witnesses today, Ms. Gadsden,
20 reading in Ms. Socks, and Mr. Altemose.

21 THE COURT: Okay.

22 MR. CLUKEY: Your Honor, if I could direct you
23 to -- this is a quote from Mr. Altemose's report. He
24 concludes that the no-change letter is the highest level of
25 IRS confirmation of a technical or legal opinion of the

1 issuance of a no change examination report.

2 This Court has already ruled that that is simply not
3 true.

4 MR. COOPER: Well, he's going to testify as an
5 industry practice when you conclude an audit, what does that
6 mean, and there is no changes to the return?

7 And it's going to mean that items on there, just
8 like I said, that they report it correctly and the conduct
9 and how you are going about reporting it is correctly. He's
10 not going to talk about what a no change means.

11 He's going to say when the audit concludes and it's
12 done with the no change, what import does that have to a
13 person's state of mind as to the items on the return and the
14 conduct they are engaging into.

15 THE COURT: I'll let him testify to that and then
16 charge the jury that a no-change letter really doesn't mean
17 anything.

18 MR. COOPER: Well, I don't think that the no change,
19 as far as a tax determination, meaning can you take that
20 deduction, the IRS can reverse itself, we've never disputed
21 that.

22 THE COURT: It's not binding. I mean, the cases are
23 legion that it is not binding on anybody about anything.
24 Isn't that right?

25 MR. COOPER: For a tax purpose. But we are talking

1 about penalty conduct.

2 This is -- the cases we cited to you, and I believe
3 I put them in the margins of my comments, they all say that
4 when the no change is issued, that that gives someone a
5 reasonable belief that they are engaged in the appropriate
6 conduct. And that's exactly what Mr. Altemose is going to
7 reinforce.

8 We don't dispute Your Honor that it's not legally
9 binding as to a tax position, but this is not a tax case,
10 it's a penalty case. There is a big difference, Your Honor.
11 I'm sorry, I mean, you said you don't do the -- you know --

12 THE COURT: And I never will again. I promise you.

13 MR. COOPER: Hopefully you will, because I live
14 here.

15 THE COURT: No, never.

16 Okay. Your proposed amendment to my charge -- and
17 I'm not going to charge where it says, as to the validity of
18 incorrect tax treatment of the 90% tax loan, he's entitled to
19 rely on the no-change letter as a defense under the 6700
20 penalty, I'm not going to charge it.

21 MR. COOPER: He can take it into consideration as to
22 his belief that he engaged -- was engaging in conduct --

23 THE COURT: What does his belief have to do with my
24 properly charging the jury on the law? I mean, you are
25 trying to get around what my charge is going to be, it sounds

1 like to me.

2 MR. COOPER: No, I'm just trying to clarify your
3 charge.

4 THE COURT: Who doesn't get to clarify my charge?
5 The people in Richmond get to clarify my charge. I mean, I
6 can't let people off the street come in here and tell them
7 what the law is before I tell them what the law is. Because
8 I've told them in the opening argument, or statement, and I'm
9 going to tell them that the law comes from me.

10 MR. COOPER: But Mr. Altemose is not going to tell
11 them the law, he's just going to say at the conclusion of the
12 audit what would be Mr. Nagy's belief that he was engaged in
13 penalty conduct.

14 THE COURT: I'm just sorry. He's not going to say
15 that. I'll look at the cases again.

16 And you know, I'm doing the best I can, I'm just not
17 going to go there. I don't think it's proper. I don't think
18 he can say that. I don't think any expert can say that as to
19 what somebody's state of mind is, but I'll look at the cases,
20 like you said, I'll look at them again. If I change my mind,
21 I'll let you know.

22 All right. Anything else on any other matter?

23 MS. WEIS: Yes, Your Honor. Just one housekeeping
24 matter.

25 As Your Honor might be aware, there is a Federal

1 Statute 26 USC Section 4103, which --

2 THE COURT: I'm sure I'm not aware of that.

3 MS. WEIS: Well, it prohibits the IRS employees,
4 among others, from testifying or revealing information about
5 other taxpayers in a case that doesn't involve them unless
6 there are specific exceptions where that taxpayer has made a
7 waiver.

8 So because Ms. Gadsden will be asked questions about
9 Scott and Whitney Cathcart, who are not parties to this
10 action, we just want to put on the record that Mr. Cooper
11 obtained a waiver from Scott and Whitney Cathcart allowing
12 them to discuss their tax return.

13 THE COURT: So that's -- that waiver allows her to
14 testify as to something she wouldn't be able to testify to
15 otherwise?

16 MS. WEIS: Correct.

17 MR. CLUKEY: Your Honor, actually, there is one
18 other housekeeping matter. Will the Government be allowed a
19 rebuttal after the closing, as part of the closing?

20 THE COURT: Yes. And then the second half of the
21 case, if we get that far, then Mr. Cooper will be allowed the
22 rebuttal.

23 I mean, the burden of proof -- the rebuttal goes to
24 the burden of proof. You have the burden of proof in this
25 half of the case. And if we have a second half of the case,

1 then Mr. Cooper gets to open and close.

2 MR. COOPER: I'm sorry. I mis -- my understanding
3 is because he opened, that when we close, I go first, because
4 I thought the local rule said that the burden of proof, that
5 he opens and ends the case, and then I will be entitled to
6 rebuttal at the end.

7 THE COURT: In this half of the case, since the
8 Government has the burden of proof, Mr. Clukey makes his
9 closing argument, you make your closing argument, and then he
10 has a rebuttal in the second half of the case, if we get
11 there. You have the burden of proof, so you get to open, Mr.
12 Clukey gets to respond, and then you get a rebuttal.

13 MR. COOPER: Thank you.

14 THE COURT: The rebuttal goes with the burden of
15 proof.

16 MR. COOPER: Thank you for that.

17 THE COURT: Okay. Sure.

18 Okay. All right. Anything else before I go look at
19 Mr. Cooper's cases?

20 MR. COOPER: Going back to Mr. Altemose, will he be
21 able to testify as to the nature of the in-depth exam it was?

22 THE COURT: I mean, you get -- you can ask him any
23 questions you want to, and they can object, and I'll rule on
24 them at the time.

25 I mean, I'm just -- I just said as a general matter,

1 looking at his report, most of the stuff in his report is not
2 admissible into evidence in the case. But I mean, there may
3 be some other things that are, that's why I brought it up. I
4 mean, I don't want to blindside you, but I'll go look at
5 those two cases again.

6 MR. CLUKEY: Your Honor, just looking at his report,
7 we fail to understand how any of this could be relevant,
8 either.

9 In his executive summary of his report, which is on
10 page 2, he says the IRS issuance of the no change report
11 generates three potential consequences, and then it goes
12 through these consequences of what the no-change letter is,
13 is trying to backdoor the meaning of the no-change letter.

14 And he starts off with IRS procedures,
15 administrative significance of the no-change letters. Mr.
16 Cooper proposing what he will testify about is to go to one
17 of these consequences, it's to underlie from an
18 administrative viewpoint, the highest -- from an
19 administrative viewpoint, the highest level of IRS
20 confirmation of a technical or legal opinion will be the
21 issuance of a no change examination report. That is the
22 sentence that precedes this discussion of the significance
23 and the depth of the audit.

24 So it's simply another way to backdoor the meaning
25 and import of the no-change letter. That's what this entire

1 report is on. There is nothing else in this report that we
2 can see that he could possibly testify about apart from that.
3 I mean, it's elicited in his executive summary and flushed
4 out a little bit more.

5 THE COURT: All right. Well, I guess we'll take one
6 step at a time. I'll go look at the cases that Mr. Cooper
7 just gave me and then we'll go from there.

8 MR. CLUKEY: And Your Honor, we also obviously cite
9 cases in rebuttal to Mr. Cooper's cases. We've got -- it's
10 our reply, actually, to Mr. Cooper.

11 THE COURT: And I'll look at 704(a), too. I don't
12 think he can do it, but I'll look at it.

13 Yeah?

14 MR. COOPER: Just with the 704(a), I can't -- it's B
15 O U Y G U E S, that case that, the page number is with the
16 portions that are relevant, 726.

17 THE COURT: Okay. Thank you. All right.

18 MR. COOPER: Our rebuttal, Your Honor, was Docket
19 Number 84.

20 THE COURT: I think we've got that, too. Okay.

21 MR. CLUKEY: Thank you, Your Honor.

22 THE COURT: Anything else? Yeah?

23 MR. COOPER: Just to hand up, as I said, I provided
24 it to opposing counsel, the proffer.

25 THE COURT: What? Okay.

1 MR. COOPER: The proffer.

2 THE COURT: Okay. Thanks. All right. We'll be
3 back down when the jury gets here. Okay. Thanks.

4 (Thereupon, there was a brief recess.)

5 THE COURT: All right. What's the batting order for
6 today, Mr. Cooper?

7 MR. COOPER: Ms. Gadsden, and reading in the
8 deposition of Ms. Socks, and then Mr. Altemose.

9 THE COURT: Okay. We looked at the cases which you
10 cited, one is a criminal case, the one out of the Seventh
11 Circuit, and the second one is the District Court of, Eastern
12 District of North Carolina, which is Judge Flanagan, who
13 allowed some sort of opinion testimony. But I'm going to
14 grant the Government's motion in limine for Mr. Altemose.

15 Mr. Altemose's testimony is based on the effect of
16 the no-change letter. As I've already said, I'm going to
17 charge the jury of what the effect of a no-change letter is.
18 And so I don't know what else he's going to testify to.

19 MR. COOPER: Well, if I understand you -- if he
20 can't talk about what import it had on Mr. Nagy, he wouldn't
21 be testifying.

22 THE COURT: So to preserve this, you know, part of
23 my job is to make a ruling. Sometimes I make the wrong
24 ruling.

25 Do you want to put in his report as your proffer, if

1 in fact you need to take it to the Fourth Circuit? I mean --

2 MR. COOPER: May I do that right now, Your Honor?

3 THE COURT: Huh?

4 MR. COOPER: May I do it right now?

5 THE COURT: I was just going to say, that's fine.

6 MR. COOPER: I believe Mr. Altemose's report -- I'm
7 objecting to your ruling. I would like to proffer
8 Exhibit 79, which is Mr. Altemose's report.

9 THE COURT: We will make that Court's Exhibit Number
10 1, all right? So it doesn't go back to the jury. And so you
11 are preserved.

12 (Thereupon, Court's Exhibit Number 1 was marked.)

13 Any objection to that?

14 MR. CLUKEY: No objection, Your Honor.

15 THE COURT: All right. And so that will -- that
16 will preserve your objection. And if I'm wrong, I'll get it
17 right next time.

18 MR. COOPER: One other thing?

19 THE COURT: Sure.

20 MR. COOPER: I don't believe I heard specifically
21 whether you ruled on pages 66 to 67 of the Socks depo.

22 THE COURT: I got sidetracked. Do you want me to
23 see it again?

24 MS. WEIS: Your Honor, I think it's actually up on
25 the counter.

1 MR. COOPER: No, I borrowed it.

2 THE COURT: I guess -- back on the Altemose issue,
3 as a general matter Rule 704(a) does permit an expert's
4 opinion on the ultimate issue. Here, Mr. Nagy wants to
5 testify on the ultimate issue of scienter, had reason to
6 know, given the change letter.

7 The problem is his conclusion is based on a
8 definition and legal import of the no-change letter that this
9 Court has already rejected; therefore, his opinion is not
10 helpful.

11 Based on the understanding of the law that the Court
12 has already observed, in addition under a 403 analysis, the
13 probative value of his testimony is greatly outweighed by the
14 prejudice and confusion of the issues.

15 So that's the ruling. And then you've got the
16 proffer on there. So if I'm wrong we'll go from there, okay?

17 All right.

18 MR. COOPER: Your Honor, one other thing, is I
19 talked to Mr. Clukey, with Ms. Gadsden, because she's an IRS
20 agent --

21 THE COURT: Yeah.

22 MR. COOPER: -- he's going to allow me to treat her
23 adversely, just --

24 MR. CLUKEY: In conjunction with that, we'll still
25 be able to cross her. Mr. Cooper agreed to that, as well.

1 THE COURT: Okay.

2 MR. COOPER: And by the way, with Ms. Gadsden's -- I
3 work with her on a regular basis, so it's just a technical
4 term that I get to ask her. She's not adverse, she's a nice
5 lady.

6 THE COURT: Okay. Well, that depends upon your
7 point of view, okay? Some taxpayers think she's adverse,
8 some taxpayers think she's not, all right?

9 MR. COOPER: And Ms. Van Bavel told me I screwed up
10 the exhibit, it's 78.

11 THE COURT: So 78 is marked as Court Exhibit Number
12 1.

13 (Thereupon, Plaintiff's Exhibit Number 78 was marked
14 as Court Exhibit Number 1.)

15 MR. COOPER: Sorry for that mistake.

16 THE COURT: That's no problem, that's what she's
17 here for.

18 And so Ms. Gadsden's first, and then we are going to
19 read this -- the deposition of Ms. Socks second?

20 MR. COOPER: Yes, Your Honor.

21 THE COURT: So let me go ahead, and while you are
22 doing Ms. Gadsden, I'm going to go ahead and read the
23 preceding pages, and then before we read that, I'll let you
24 know, okay?

25 All right. Anything else before?

1 MR. CLUKEY: No, Your Honor.

2 MR. COOPER: I think I brought it up with Ms. Weis
3 also in the Socks testimony, it's page 26, line 8, through
4 page 27, line 6, and page 38, 19 through page 39, line 3,
5 it's a similar issue.

6 THE COURT: Okay. And I would say that's okay.

7 MS. WEIS: Actually, before we received your
8 rulings, we had agreed that those were counter designations
9 that we were going to withdraw based on the motion in limine.

10 THE COURT: Now I don't know where we are. What
11 does that mean? Are you going to read them or not?

12 MR. COOPER: I was planning on not reading them.

13 THE COURT: You agree with them not reading them?

14 MS. WEIS: Correct.

15 THE COURT: Okay. Good. Thanks.

16 Okay. Anything else? All right. Now -- all right.
17 So what we need to do, then, is Ms. Gadsden, read the Socks
18 deposition, and then you rest, right?

19 MR. COOPER: Yes, Your Honor.

20 THE COURT: Are you going to anticipate any reply?

21 MR. CLUKEY: We reserve our right, but we do not
22 anticipate any reply.

23 THE COURT: What we'll do is after that, I'll let
24 the jury go have lunch, we'll go over the final charge, and
25 then we'll argue and charge this afternoon, okay? Any

1 problem with that?

2 MR. CLUKEY: No, Your Honor.

3 THE COURT: I mean, I think y'all have had most 99.9
4 percent of the final charge over the weekend, so I guess I've
5 made some rulings on your objections, and I think we
6 incorporated them, and then we'll give you those, we'll argue
7 about them while they are -- and then because I've got to
8 make copies for each one of the jurors.

9 MR. COOPER: Before we start, may I grab your
10 version of the testimony so we can use it reading --

11 THE COURT: What version of the testimony?

12 MR. COOPER: Ms. Socks to read in.

13 THE COURT: Yeah. Let me make a ruling on it -- do
14 you want to read it now?

15 MR. COOPER: No, Your Honor. You are right. I'm
16 sorry.

17 THE COURT: I'm going to -- I'm going to rule on 67,
18 68, and then I'll give it to you. I don't think you have it
19 memorized, so I'll let you read it from the deposition
20 transcript.

21 MR. COOPER: Thank you.

22 THE COURT: All right. Any problem with that? So
23 how long do you think, two hours this morning?

24 MR. COOPER: Well, that would be a fair assessment.

25 THE COURT: Okay. Bring in the jury.

1 (Thereupon, the jury returned to the courtroom.)

2 THE COURT: Okay. Ladies and gentlemen of the jury,
3 welcome back. I hope y'all had a nice weekend. We are going
4 to continue with this case here this morning.

5 Based on my experience yesterday, as a recovering
6 lawyer, I'm going to give you some legal advice, never, ever,
7 ever, fly through Atlanta in the summer, okay?

8 So with that in mind, we'll start and continue with
9 the testimony in this case.

10 Yes, sir, Mr. Cooper?

11 MR. COOPER: We call Revenue Agent Neva Gadsden.

12 THE CLERK: Right here, Ms. Gadsden.

13 Place your left hand on the Bible and raise your
14 right hand.

15 State your name for the record.

16 THE WITNESS: Neva Gadsden.

17 THEREUPON:

18 MS. NEVA GADSDEN,
19 Called in these proceedings and having been first duly sworn
20 testifies as follows:

21 THE CLERK: Thank you. Be seated over on the
22 witness stand.

23 DIRECT EXAMINATION

24 BY MR. COOPER:

25 Q. Good morning, Ms. Gadsden.

1 A. Good morning.

2 Q. Would you state your full name, please.

3 A. Neva A. Gadsden.

4 THE COURT: Ms. Gadsden, would you pull that
5 microphone over closer to you and speak into it, so that
6 everybody can hear you? Okay.

7 THE WITNESS: Neva A. Gadsden.

8 Q. And Ms. Gadsden, where do you work?

9 A. For the IRS here in Charleston.

10 Q. And what position do you hold with the Internal Revenue
11 Service?

12 A. I'm a --

13 THE COURT: Wait a second. Move it a little bit
14 closer to you. You can pull that whole thing -- the chair
15 doesn't move, but the microphone does.

16 THE WITNESS: Is that better?

17 THE COURT: I want to make sure everybody can hear
18 you. Okay. Great.

19 Q. I'm sorry. I'll ask it again. What position do you hold
20 at the Internal Revenue Service?

21 A. I'm a revenue agent.

22 Q. And how long have you been a revenue agent?

23 A. 22 years, since January, 1988.

24 Q. And do you hold any licenses or certifications?

25 A. I'm a CPA licensed in South Carolina.

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1 Q. And when did you get your CPA license from South
2 Carolina?

3 A. January 1991.

4 Q. And in order to keep that license, you have to do
5 continuing education on tax and accounting issues?

6 A. Yes, um, actually, there was a period of time since I
7 worked with the Government that I didn't have to do CPA, but
8 now I do.

9 Q. And do you still hold that license today?

10 A. Yes.

11 Q. And then can you explain to the jury that, as an IRS
12 revenue agent, what you do?

13 A. I audit tax returns.

14 Q. Well, we use that word a lot. Can you tell them what an
15 audit is?

16 A. It depends on if it's an individual 1040, a corporate
17 return, a partnership return. The taxpayers, on their
18 returns, sign their audit. We generally tell them what
19 issues appear to be the -- are the ones that we want to
20 address on the returns, schedule an appointment and meet with
21 the taxpayer, interview them.

22 If it's a business return, we find out about how --
23 what their business is, how they keep their books and
24 records, because that way our job will be a little bit
25 easier, so that we understand what they are doing. And we

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1 look at their books and records and try to decide if the
2 return is correct.

3 Q. And when you look at the return, are you trying to decide
4 if the income is reported correctly?

5 A. Right. The income is properly recorded and that expenses
6 that are on the return are allowed as deductions.

7 Q. So you also look at the expense and deduction side, too,
8 of your return?

9 A. Um-hum. Yes.

10 Q. Thank you.

11 And then you mentioned during the initial meeting
12 you want to learn, if it's a business, you want to learn
13 about the business. Why would you want to learn about the
14 taxpayer's business?

15 A. Well, it helps us understand how they record
16 transactions, what their sources of income are, how they
17 determine whether the income is -- when it's earned, what to
18 keep in their accounting records, the flow of transactions.
19 It helps us evaluate internal control, and the controller of
20 the income as it comes in, or the assets of the business, and
21 it's interesting, too.

22 Q. And as part of an audit, too, are you trying to determine
23 whether any penalties would be appropriate?

24 A. Yes. Um, if -- generally the penalties that I assess as
25 a revenue agent are based on tax law, if there is an increase

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1 in tax or a tax liability. So yes, we are evaluating whether
2 penalties, taxpayer penalties are applicable.

3 Q. And do you know Mr. Nagy?

4 A. Yes.

5 Q. And do you know him from the audit that you did of
6 Derivium and Scott Cathcart?

7 A. Yes. I think that's the only case I ever worked with Mr.
8 Nagy, I think.

9 Q. And what was Mr. Nagy's role in the audits of Derivium
10 and Mr. Cathcart?

11 A. He was their representative. He's the -- actually, he
12 stood as their representative, as their taxpayer.

13 Q. And when you say "a representative," we have been using
14 the word power of attorney.

15 A. Um-hum.

16 Q. Are those interchangeable?

17 A. We usually call them power of attorneys, yes, because
18 they give them power of attorneys, you act on taxpayers'
19 behalf in regards to the audit.

20 Q. And you received power of attorney forms from Mr. Nagy so
21 he could represent his taxpayers?

22 A. Yes.

23 Q. And like you said, through the audits of Derivium and Mr.
24 Cathcart, did you communicate information through Mr. Nagy?

25 A. Well, yes. If I was sending letters and stuff, I would

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1 send a letter to the taxpayer and to Mr. Nagy.

2 Q. Because the representative gets copied on all the
3 correspondence, correct?

4 A. Correct. But if I was making phone calls, I wouldn't
5 call the taxpayer and Mr. Nagy, I would call Mr. Nagy.

6 Q. And Mr. Nagy, he also communicated information to you
7 that his client provided him?

8 A. Yes. That's how it's represented to me.

9 Q. And during an audit, I'm going to show you what's been
10 premarked as Nagy Exhibit Number 4. Is this your activity
11 record?

12 A. Yes.

13 Q. I should say redacted version of your activity record?

14 A. Um, yes. This is an -- even though I don't have the
15 taxpayer's name, I'm assuming it's for the Derivium audit.

16 Q. Okay. Because you said that was the only case you ever
17 worked with Mr. Nagy?

18 A. Yes.

19 And then also -- well, there is other -- I've got a
20 little number up here that tells me what case file number it
21 is in our computer program, and that's a 1065, so that's the
22 type of return. So it's a partnership return.

23 Q. And the un -- did you keep this -- is this part of a
24 document you generate as part of being a revenue agent?

25 A. Yes. Yes. We record all -- we date -- there is little

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1 codes here, there is a date. And any kind of significant
2 activity on the case, any work that we do, contacts that we
3 make, are recorded on the activity record.

4 Q. And do you keep this document in the ordinary course of
5 conducting your duties as an IRS agent?

6 A. Yes.

7 Q. Okay. And then if you flip through here, the unredacted
8 versions, do they indicate times when either you communicated
9 to Mr. Nagy or Mr. Nagy communicated to you?

10 A. Well, this one -- you are saying would I normally do?

11 Q. No, I'm talking about the actual entries in Exhibit 4.
12 Do those notes reflect when either you communicated to Mr.
13 Nagy or Mr. Nagy communicated to you?

14 A. Yes. What I can see, without reading every page, but it
15 looks like, yeah, these are phone calls for Nagy.

16 MS. WEIS: Objection, Your Honor. The exhibit is
17 not yet in evidence.

18 THE COURT: Okay.

19 MR. COOPER: I would move it into evidence.

20 THE COURT: Any objection?

21 MS. WEIS: Yes, we have an objection. Your previous
22 motion in limine ruling as to what was and was not
23 communicated to Mr. Nagy.

24 THE COURT: Okay. I'll sustain the objection for
25 the time being, but she can use it to refresh her

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1 recollection as to any contact that she had with Mr. Nagy and
2 Mr. Nagy to her, okay?

3 MR. COOPER: Okay. Let me take that back.

4 Q. And then you had also mentioned at the beginning of your
5 audit that you have an initial meeting with the taxpayer; is
6 that correct?

7 A. Yes. We call it an initial interview.

8 Q. And did you have an initial interview with Mr. Nagy
9 during the Derivium exam?

10 A. Yes.

11 Q. And do you recall if that initial interview was on
12 December 4th?

13 A. No, not really.

14 Q. Would your activities transcript help you refresh your
15 recollection?

16 A. Oh, um, well, I believe -- I believe the December
17 meeting -- when Mr. Nagy and I first talked, um, I faxed him
18 a copy of our -- my initial information document request.

19 Q. Right.

20 And let me show you Exhibit Number 1. Is this the
21 initial information document request you sent to Mr. Nagy?

22 A. Yes. I faxed that to him and then I think he and I met
23 on the 4th and actually talked about the information document
24 request and what was relevant or, you know, what -- like,
25 this was kind of a standard one that went out to a business

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1 return. And there is things in here that we just discussed
2 what they have, what they didn't have, what was relevant for
3 Derivium.

4 Like just as an example, I've got -- number 16 lists
5 beginning and ending accounts payable and accounts
6 receivable. I think Derivium was on a cash basis, so that
7 may not have been relevant.

8 Q. So before your meeting with Mr. Nagy on December 4th, you
9 faxed the IDR to him beforehand?

10 A. Um-hum. And then we talked on the 4th and he told me
11 what they had and what they didn't have.

12 Q. And then on the 4th, do you recall if you took notes
13 during that meeting?

14 A. I don't think so because I think we were just going over
15 the information document request. I really don't think I
16 took any notes. I may have taken notes on my copy, just so
17 that I would know, you know, when we did have our initial
18 interview that those documents weren't relevant, or that that
19 item on the document request didn't fit Derivium.

20 Q. So when you had the initial interview, did you have a
21 more in-depth discussion about the business of Derivium?

22 A. Yes.

23 Q. And during the initial interview, do you recall if you
24 took handwritten notes during that interview?

25 A. Yes, I did.

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1 Q. And I'll hand you what has been marked as Nagy's Exhibit
2 Number 5, and they're Bates marked U.S. 15 at the bottom --

3 A. Um-hum.

4 Q. -- through 28. And in the back, there is a type written
5 form in the document.

6 Does that form reflect the questions that you would
7 have asked Mr. Nagy during the initial interview?

8 A. Yes.

9 Q. And the handwritten notes before the form, are those the
10 answers that Mr. Nagy communicated to you during your
11 interview?

12 A. Yes.

13 Q. And did you take these notes in the ordinary course of
14 being a revenue agent?

15 A. Yes.

16 Q. And did you keep them in your audit file as part of your
17 practice?

18 A. Yes.

19 MR. COOPER: Your Honor, I would like to move this
20 in as reflective of what Mr. Nagy communicated to Ms.
21 Gadsden.

22 MS. WEIS: Your Honor, we have the same objection.
23 This particular document falls within the motion in limine
24 ruling.

25 THE COURT: Let me see it.

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1 MS. WEIS: Your Honor, we believe that these notes
2 would be the same sorts of thing as an attorney taking notes
3 in context of a witness. It's reflecting what they are
4 interpreting, not necessarily what all the books say.

5 THE COURT: She can clearly say what Mr. Nagy told
6 her.

7 MS. WEIS: Of course.

8 THE COURT: And she can clearly say what she told
9 Mr. Nagy.

10 MS. WEIS: Correct. We object to offering that
11 exhibit into evidence. We don't have any objection to
12 switching to the prior exhibit used to refresh her
13 recollection as to what she was communicating.

14 MR. COOPER: She just testified that that was what
15 Mr. Nagy communicated to her.

16 THE COURT: The last three pages of the form is what
17 you focus your question on. I don't know whether it was all
18 of these notes.

19 MR. COOPER: Well, if I can clarify?

20 THE COURT: Sure. That's fine.

21 Q. The firsthand written notes before you get to the
22 typewritten form, those are the notes that you took of what
23 Mr. Nagy communicated to you in response to questions,
24 correct?

25 A. Yes. Yes.

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1 THE COURT: Go ahead.

2 THE WITNESS: They are not word for word, I guess,
3 is that what -- you know, it's not -- I can only write so
4 fast. And so as people tell me things, you know, there is
5 missed spellings and abbreviations and things in there, as
6 well, so it's not verbatim.

7 THE COURT: Okay. Go ahead and ask her what she
8 told him and he told her. She can use her notes to refresh
9 her recollection. I'll think about whether you can put them
10 all into evidence. And I'm not saying it's not coming in,
11 I'm not saying it is coming in, I need to listen to it.

12 MR. COOPER: May I remain a copy with her?

13 THE COURT: Sure.

14 Q. And these notes, again, reflect what you discussed with
15 Mr. Nagy about the business of Derivium, correct?

16 A. Yes.

17 Q. And then if you turn the page to U.S. 16.

18 MS. WEIS: Objection, Your Honor. The document is
19 not in evidence. He hasn't established that she has a need
20 to refresh at this point.

21 THE COURT: I am not going to ask you to go through
22 that dance and ask her if she remembers five years ago every
23 time he wants to ask her a question, all right?

24 So overruled.

25 Q. And if you look at the first part of its addenda, does

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1 that help you recall if Mr. Nagy told you that Derivium made
2 its money from marketing and administering loans?

3 A. Yes.

4 Q. And then right below that, did Mr. Nagy start to discuss
5 to you the mechanics of the stock loan transaction, um,
6 meaning the borrow of transferred stock to Derivium that held
7 the stock as collateral for the loan? Did Mr. Nagy tell you
8 that?

9 A. Yes. This is, um, I'm trying to capture what he's
10 telling me in these notes.

11 Q. Okay. And he also told you that that worked with one
12 lender?

13 A. Correct.

14 Q. And if you look down farther, to help you with the little
15 slashes, did he tell you the dividends were applied against
16 the interest that accrued on the loans?

17 A. Yes.

18 Q. And did he also tell you that there was -- it was a
19 nonrecourse loan during this interview?

20 A. Correct.

21 Q. And he also told you that it was Derivium's position that
22 there was a no capital gains for the loan transaction?

23 A. That's what he told me, correct.

24 Q. And he also told you that Derivium operated nationwide in
25 marking and administering these loans?

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1 A. They operated nationwide. And I didn't understand what
2 you said at the end.

3 Q. They operated nationwide with respect to their business?

4 A. Correct.

5 Q. And then if you flip back to U.S. 20.

6 And again, y'all started discussing the stock loan
7 transactions, right?

8 A. Yes.

9 Q. And Mr. Nagy told you that the lender turned around and
10 loaned the money within two or three days?

11 A. This is what -- yes. This is what he told me. There is
12 a two- to three-day turnaround time.

13 Q. And he also told you that the loans were noncallable and
14 nonprepayable during the interview?

15 A. That's what he said.

16 Q. And he also explained to you that at the end of the
17 transaction, there were three things that the borrower could
18 do, that he could pay off the loan and get the stock back,
19 default, and the borrower would incur a capital gain, or they
20 can renew the loan?

21 A. Correct. That's what I have written down that he told
22 me.

23 Q. And then if you go down from there, he also told you --

24 THE COURT: Mr. Cooper, Ms. Weis, come over here,
25 please.

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1 (Thereupon, there was a brief off-the-record
2 discussion.)

3 THE COURT: Nagy 5 in evidence.

4 (Thereupon, Plaintiff's Exhibit Number 5 was
5 received in evidence.)

6 Q. So when we were just discussing your notes, when I asked
7 you about the three options for the client, that would have
8 been what this note reflected right there at the maturity?

9 A. Correct. That's what he was telling me.

10 Q. And did he also tell you that it was his belief that the
11 lender didn't have to file 1099s with the IRS?

12 A. Yes. Correct.

13 Q. And he also told you below there that Derivium, instead
14 of 1099s, issued statements to clients reflecting the
15 dividend on them?

16 A. Yes.

17 Q. And down here again, he tells you that it is -- there is
18 no gain on the transaction because it's a loan?

19 A. He said it's not a sale, it's a loan transaction.

20 Q. Right. So this would have been a second time he told you
21 that that we've gone over?

22 A. Correct.

23 Q. And also during the interview, he disclosed to you that
24 the lender in 1998 was Diversified Design?

25 A. Yes. I'll do my best on that one. I'm sorry.

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1 Q. And then in 2002 during this meeting, that the lender was
2 Bancroft Ventures Ltd.?

3 A. Correct.

4 Q. And he told you that Bancroft was on the Isle of Man?

5 A. Correct.

6 Q. And then you also asked him questions about related
7 returns. What's a related return?

8 A. Um, this was a partnership return, so the partners'
9 returns would be related returns. And then if there is
10 interest with common holdings, they, you know, the same three
11 people had interest in other entities, those are related
12 returns, as well, or potential related entities.

13 Q. So Mr. Nagy down here told you that Alert Holdings was a
14 related return?

15 A. Yes.

16 Q. And actually wasn't that a predecessor to Shenandoah?

17 A. I don't know.

18 Q. And he also discussed the Charleston Construction being a
19 related return?

20 A. Well, in here -- well, right now to even understand what
21 I was drawing -- I think I was trying to capture that Alert
22 Holdings had the, um, the three partners of this LLC, or
23 members, or members of Alert Holdings, but also Charleston
24 Construction and three C's were in that.

25 But again, you know, this is what I'm trying to

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1 capture with this little drawing, and I don't think I did a
2 very good job.

3 Q. Okay. Like you said, people talk fast and you do the
4 best you can to take notes? I'm sorry. You have to answer,
5 Ms. Gadsden.

6 A. Yes.

7 Q. Thank you.

8 And then again, I believe here the DDA account, he's
9 the -- are y'all discussing how the loan transactions are
10 recorded to the borrower -- to the lender?

11 A. No, I think we are discussing how they were recorded on
12 Derivium's books.

13 Q. Okay. So Derivium's reporting what's owed the lender?

14 A. Well, what -- Derivium got this stock. I think this is
15 how Derivium records getting the stock on their books.

16 And then let's see, because the first entry is a
17 debit to cash, which cash goes into the bank, and the credit
18 to the broker account. And this is money coming from DDA to
19 Derivium. And then they would make another entry to debit
20 the stock loans and credit the cash, and when Derivium was
21 first to the borrower.

22 Q. Okay. I -- so I guess my takeaway from your answer was,
23 they were recording the stock loans on Derivium's books?

24 A. Yes. That's -- this is how it was represented to me.

25 Q. And you had mentioned brokerage accounts. Were you aware

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1 that the stock was being sold in brokerage accounts?

2 A. At some point, yes. Um, I think earlier -- that earlier
3 page you referenced.

4 Q. Yes, ma'am. This one?

5 A. No, that was right -- it was at the beginning of my
6 notes. On this page.

7 Q. Yes, ma'am.

8 A. Well -- the broker's stock -- borrower's stock, rather,
9 is transferred to Derivium, who holds as collateral on the
10 right. So it was -- the borrower's stock was transferred to
11 Derivium, who holds as collateral on behalf of the lender.
12 They work with one lender who is not related to Derivium.

13 And there were -- these were not mortgages, they
14 were unsecured loans, or they were not mortgages or unsecured
15 loans.

16 Q. And I guess my question was, is from your discussions,
17 did you understand that Derivium accounted for these loans on
18 its books?

19 A. I was getting the impression that Derivium was more a
20 conduit, you know, the money came into and out of Derivium.
21 I really don't remember who recorded the loans. I don't
22 recall that.

23 Q. But I guess you were talking about credits and debits.
24 And would those be entries in Derivium's books?

25 A. Right.

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1 And I think in my notes it says the money, that
2 there was money going in and out of Derivium from DDA, then
3 to the borrowers, and Derivium got a percentage.

4 And this is all I think, you know, what Mr. Nagy was
5 telling me, Derivium earned its income as a percentage of
6 diverse loans that they facilitated --

7 Q. Yes, ma'am.

8 A. -- and DDA and Derivium sold at the end of the year.

9 Q. Okay. And then going back to U.S. 22, you took some
10 additional notes on the stock loan transaction, that the
11 client could borrow up to 90 percent of the stock loan?

12 A. Yes.

13 Q. And down here at the bottom, not forgiveness of debt.

14 Do you recall discussing the tax treatment upon a
15 customer's default?

16 A. And this I was telling -- writing down what Mr. Nagy was
17 telling me, that this was not forgiveness of debt. I can't
18 read the other things. Again, I'm writing fast with a
19 pencil. So sometimes -- I had what he wrote for POA is
20 shorthand for power of attorney.

21 Q. And did -- during the initial interview, did Mr. Nagy
22 answer all the questions that you asked?

23 A. Yes.

24 Q. And you were talking about debiting and crediting. This
25 has been introduced as Exhibit Number 7.

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1 THE CLERK: What was the number?

2 MR. COOPER: 7.

3 Q. Do you recall if this -- you see at the top up here it
4 says "Due to DDA." Do you recall Mr. Nagy giving you the
5 financials of the company so you could look at the due to DDA
6 issues?

7 A. I got books and records of Derivium, yes. Well actually,
8 they were computer and electronic format.

9 Q. Right.

10 And Mr. Nagy actually set up a work station for you
11 at his office?

12 A. Correct.

13 Q. And I believe you testified you spent a couple of days at
14 his office going over books and records?

15 A. I think I was there two days. Well, yes, I was there two
16 days. Part of the day was spent talking to Mr. Nagy and then
17 I think another day part of that day we were actually walking
18 around Derivium's office.

19 Q. Oh, so they took you to 1 Poston Road and showed you
20 around?

21 A. Um-hum.

22 Q. Right.

23 And I think I mentioned this earlier, the IRS office
24 is now located at 1 Poston Road, isn't it?

25 A. Correct.

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1 Q. And when you went to his office, you said he gave you the
2 books and records on a diskette. What does that mean?

3 A. They were electronic, it was a little disk, and he had a
4 terminal set up of, you know, a work station kind of terminal
5 that I could flip through and look at pages. And I think I
6 could print out pages as I needed them. It was -- you know,
7 it wasn't a paper thing. I don't think I got paper books and
8 records.

9 Q. So when you say "terminal," do you mean a computer?

10 A. Yeah. Like a -- well, I think it was like a dumb
11 terminal. All I could do is put in the disk and bring it
12 out. I couldn't access anything else.

13 Q. You couldn't access his file?

14 A. No.

15 Q. It was a stand-alone computer, is what you are saying?

16 A. Yes.

17 Q. He gave you the books and records on a CD and you had the
18 ability to print those if you wanted?

19 A. Yes. Um, it was quite voluminous. There were a lot of
20 pages in there, so a lot of stuff I would have on screen, I
21 think, or -- and just printed out pages and -- a number of
22 papers.

23 Q. And was there anything with regard to the books and
24 records that you asked for that wasn't provided to you by Mr.
25 Nagy?

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1 A. No. I think he -- um, if I asked for something, then he
2 gave it to me.

3 Q. And would you say that during the audit that Mr. Nagy
4 cooperated with you?

5 A. Um-hum. Yes.

6 Q. And in fact, I think it was described as being very
7 cooperative?

8 A. Yes. He was very professional, very cooperative.

9 Q. Now, because of the initial interview -- oh, and on the
10 general ledger where it says "broker activity," you see J.C.
11 Bradford. Do you understand J.C. Bradford to be a brokerage
12 house?

13 A. In relation to Derivium, or just general?

14 Q. Just in general?

15 A. Yes.

16 Q. And more specifically, did you understand that J.C.
17 Bradford appeared on Derivium's books and records?

18 A. Now I don't remember.

19 Q. Now, besides asking Mr. Nagy for information, does the
20 IRS have summons authority?

21 A. Yes.

22 Q. So a summons is an administrative document that requires
23 people to either turn over records or provide testimony?

24 A. Yes.

25 Q. And you can also issue that summons out to third parties

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1 to get information, too?

2 A. Yes.

3 Q. So with the brokerage houses, a summons could be issued
4 to the brokerage houses for their records?

5 A. Yes. Um, as a -- we generally try to get things directly
6 from the taxpayer. Because a summons is, um, it -- it's kind
7 of a last resort way to get records. And I don't want to say
8 last resort, but the taxpayer is unwilling or unable to
9 provide records and read them to make a determination, and
10 then we'll issue a summons. We have issued summons where the
11 records exist, the taxpayer can't afford to get them, to go
12 to the bank and have copies of their bank statements made, so
13 we'll issue a summons to get that information.

14 Q. And that was my question, because Derivium was willing
15 and they were able to produce the records, you didn't have to
16 resort to any other sources to get information?

17 A. Correct.

18 Q. And during the initial interview, Mr. Nagy made you aware
19 of the loan transaction, correct?

20 A. How Derivium derived this income, was facilitating the
21 loans?

22 Q. Yes, ma'am.

23 A. Correct.

24 Q. And --

25 THE CLERK: What's that document?

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1 MR. COOPER: Yes, ma'am. It's the second page of
2 Exhibit Number 1.

3 THE CLERK: Okay.

4 Q. And what's this document?

5 A. This is an information document request.

6 Q. And was this request more specific to the loan
7 transaction?

8 A. Yes.

9 Q. And did Mr. Nagy respond to your IDR?

10 A. Yes. And there is probably a due date at the bottom on
11 how to respond, so I had checked -- we hadn't planned
12 appointments. I don't know whether he was supposed to mail
13 it in or whether I was going to pick it up.

14 Q. Okay. And Exhibit Number 12 that's already into
15 evidence, is this Mr. Nagy's response to your second IDR?

16 A. Yes.

17 Q. And I'm going to hand you what is Exhibit Number 8, which
18 is U.S. 62 through 69. And did Mr. Nagy provide you the
19 stock loan agreement that you asked for?

20 A. Yes. This was the Master Agreement. I think it's --
21 it's a sample.

22 Q. And also in the IDR, didn't you ask for a copy of the
23 contract between the lender and Mr. Nagy?

24 A. Well, if you put the IDR back up there, I'll put that in
25 again.

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1 Q. I believe it's point number two.

2 A. A copy of the contract with the lender that specifies the
3 duties of the taxpayer and how compensation is determined and
4 paid, and then how they determine what their 1998
5 compensation was for the Tax Code.

6 Q. And do you recall if Mr. Nagy provided you with a copy of
7 that contract?

8 A. Well, in the cover letter you just had up there, it was
9 either to --

10 Q. Then I'm going to show you what is U.S. 55 through 61.

11 A. Do you want this one back?

12 Q. And it is a portion of Exhibit 86, which is the IRS audit
13 file.

14 Ms. Gadsden, does this look like a copy of the
15 contract between Diversified Design Associates and First
16 Security Capital?

17 A. As of January 1, 1998, the two parties are Diversified
18 Design and First Security.

19 Q. And from the Bates numbers, was this a document provided
20 to you in response to number 2 that was kept in your audit
21 file?

22 A. I'm sorry?

23 Q. Was this contract a document that was provided to you by
24 Mr. Nagy in response to question number 2?

25 A. It appears so. I really -- if this is what he's

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1 referencing in his letter, then he gave it to me.

2 Q. And did you keep that document as part of your audit
3 file?

4 A. Yes.

5 Q. Did you keep it as part of your ordinary course of
6 business?

7 A. In my audit file?

8 Q. Yes, ma'am.

9 A. Yes.

10 MR. COOPER: Your Honor, I would like to move in
11 pages 55 through 61 of Exhibit 86.

12 MS. WEIS: Can we just get a copy of what --
13 Exhibit 86 is quite a few.

14 THE COURT: Right.

15 MR. COOPER: It's U.S. 55.

16 MS. WEIS: Your Honor, can we request a side bar to
17 discuss this exhibit?

18 THE COURT: Okay. Y'all can stand up and stretch if
19 you want to.

20 (Thereupon, there was a brief off-the-record
21 discussion.)

22 (In open court:)

23 THE COURT: Okay. All right. I'll overrule your
24 objection. You can -- let's mark it as a separate exhibit as
25 an apart from the part of the huge exhibit. So it's the next

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1 one.

2 MR. COOPER: I believe it's 101.

3 THE CLERK: 101.

4 THE COURT: Plaintiff's 101 into evidence, subject
5 to the Government's objection, which we can discuss and put
6 on the record.

7 (Thereupon, Plaintiff's Exhibit Number 101 was
8 received in evidence.)

9 Q. And we were talking about the contract between First
10 Security Capital and DDA before we broke. Do you recall
11 that?

12 A. Yes.

13 Q. And those handwritten notes at the top, those are your
14 reports indicated as part of your audit file?

15 A. Correct.

16 Q. And was this a document that was provided to you in
17 response to your request number 2 in the IDR for a contract,
18 correct?

19 A. As best as I can remember, yes.

20 Q. And you wanted the contract to ensure that their
21 percentage of management fee, what that was that was shown on
22 the contract?

23 A. Correct.

24 Q. Right.

25 And in fact, at the end of the audit, didn't the

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1 income reported by Derivium match the percentage that was
2 called for in the contract?

3 A. Without looking at my case file -- and yes, I remember
4 doing a computation, or Bob provided a computation, to verify
5 that Derivium's income was correct as recorded.

6 Q. And again, in response to IDR number 2, did Mr. Nagy
7 provide anything you asked for?

8 A. As best as I can recall, yes. I didn't have to issue
9 another IDR.

10 Q. And then at some point other agents got involved in the
11 audit?

12 A. Yes.

13 Q. Can you tell the jury who they were?

14 A. Mary Socks, who was a financial products specialist, and
15 the other was Frank Guida, who was an international agent.

16 Q. And Ms. Socks, um, what's your understanding of a
17 financial products specialist?

18 A. There was a mention of hedging transactions which I don't
19 understand, and that's the kind of work that she did. So
20 that's why he made a referral for a financial products
21 specialist to do what they -- she needed to do in regards to
22 the hedging transactions.

23 Q. And when you say specialty, what's your understanding of
24 what their specialty is, financial products specialist?

25 A. I -- well, I really don't understand what hedging

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1 transactions are, um, so their job is to evaluate the -- what
2 the document -- what the taxpayer provides to see if they are
3 doing them correctly or reporting their income correctly.

4 And that's --

5 Q. What about assist with the loan versus sale issue?

6 MS. WEIS: Objection, Your Honor, foundation.

7 THE COURT: Overruled.

8 THE WITNESS: I'm sorry?

9 Q. What about -- was Ms. Socks to assist with the loan
10 versus sale issue?

11 A. I think originally what I recall -- well, I don't
12 remember -- I don't have my referral with me, um, what my
13 manager -- and I think that we needed to make a referral
14 because --

15 MS. WEIS: Objection, Your Honor. Motion in limine.

16 THE COURT: Okay. I'll sustain that.

17 Why don't you lay a foundation for that question?

18 Q. Let me show you page 3, which is the mis -- what's this
19 document?

20 A. Well, um, since it says at the top FP001, and it's an
21 information document request, it appears to be Mary Socks's,
22 or the financial products person's, information document
23 request.

24 Q. And that's her name at the bottom?

25 A. Um-hum.

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1 Q. Now, what's the subject matter of the IDR?

2 A. Loans and hedging activities.

3 Q. Does that help you recall whether Ms. Socks was brought
4 in to assist with the loan versus sale issue?

5 A. Again, I don't have the referral, so --

6 Q. Did you think a loan versus sale issue was something you
7 could resolve independently?

8 A. No.

9 Q. And that's why you sought the help of the financial
10 products specialist, correct?

11 A. Yes, because it was a transaction that we didn't know
12 whether it was an appropriate transaction.

13 Q. And in fact, it was your belief that the loan versus sale
14 issue --

15 MS. WEIS: Objection, Your Honor.

16 THE COURT: You would have to rephrase that
17 question. I mean, she -- she already said she doesn't know.
18 I mean --

19 Q. Did you -- Ms. Socks's IDR, did you review this before it
20 was sent out?

21 MS. WEIS: Objection, Your Honor. Motion in limine.

22 THE COURT: Overruled. She can answer that yes or
23 no.

24 THE WITNESS: I don't think so. I think Mary sent
25 me a copy after it was sent to Mr. Nagy.

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1 Q. And did this IDR ask specific questions about the hedging
2 transactions?

3 A. I put what she sent me in my case file. I don't know if
4 I really looked at it that hard to see what she was asking
5 for, but Mr. Nagy was responding directly to her and not
6 through me.

7 Q. Were you ever privy to any communications where Ms. Socks
8 said to Mr. Nagy he wasn't cooperating?

9 A. No. I don't understand what you -- what you mean by
10 privy, can you --

11 Q. Did you participate in any conversations where Ms. Socks
12 told Mr. Nagy he wasn't cooperative?

13 A. No, I don't think so. I don't think we had any
14 conference calls with me, Mary and Mr. Nagy, and I don't
15 recall them.

16 Q. And do you recall any part of any conversations with Mr.
17 Nagy where Ms. Socks said that Mr. Nagy didn't provide all
18 the information requested?

19 THE COURT: I mean, she already said she didn't have
20 any three-way conversations, and so that question is asked
21 and answered. So I'll sustain the objection.

22 Q. Was it your understanding that Mr. Nagy was cooperative
23 with Ms. Socks's requests?

24 MS. WEIS: Objection, Your Honor, foundation.

25 THE COURT: Sustained.

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1 Q. To your knowledge, um -- and then what's an international
2 examiner?

3 A. There's -- this is my understanding. There is treatise
4 between the United States and other countries about tax
5 matters and transactions. And the international agents --
6 there is some type of international component -- we can
7 request their assistance to see if it's within the realms of
8 those treatise.

9 And because there was a foreign lender, um, we made
10 a referral for an international agent to evaluate something
11 called permanent establishment, which again, that's another
12 term that I don't understand, but it had something to do with
13 the fact that there was an international component.

14 Q. And again, you were able to make the referral for the
15 international examiner because Mr. Nagy disclosed to you the
16 existence of the international lender, correct?

17 A. Right. He told me that the international -- that the DDA
18 was a foreign entity and there was no relationship or common
19 ownership between DDA and Derivium.

20 Q. And you were able to make the referral to the financial
21 products specialist because Mr. Nagy described to you the
22 stock loan transaction?

23 A. Correct.

24 Q. And in fact, because Mr. Nagy told you in the initial
25 interview you were able to identify the loan versus sale

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1 issue quickly in the examination, right?

2 MS. WEIS: Objection.

3 THE COURT: You are not --

4 MS. WEIS: Sorry, Your Honor.

5 THE COURT: -- talking very loud, okay?

6 MS. WEIS: An attempt not to speak quickly.

7 THE COURT: I'm getting old and I can't hear you
8 very well.

9 MS. WEIS: Objection, 602. Already covered the loan
10 versus sale issue.

11 THE COURT: Unless you lay a foundation for that
12 issue, which I don't think you've laid that, I'll sustain the
13 objection.

14 Q. Mr. Nagy, in the initial interview, disclosed the stock
15 loan transaction to you, right?

16 A. He disclosed how Derivium arrived at its income and
17 facilitating the loan and that 90 percent of the loans that
18 are facilitated.

19 Q. But he also told you the borrower transfers the stock?

20 A. Right. That's what I have in my notes, the borrowers
21 transfers its stock to Derivium.

22 Q. And he also told you the loan turnaround time was two to
23 three days?

24 A. Right. Yes.

25 Q. He also told you the lender engaged in hedging

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1 transactions, right?

2 A. I'm not sure if the lender did or Derivium did.

3 Q. But he told you they engaged in a hedging transaction?

4 A. Right.

5 Q. He told you it was a nonrecourse loan?

6 A. Yes, it is.

7 Q. He told you the stock was the collateral?

8 A. Yes.

9 Q. And from those communications to you, did that allow you
10 to identify the loan versus sale issue early in your
11 examination?

12 MS. WEIS: Objection, Your Honor, 602.

13 THE COURT: I'll sustain that objection.

14 Q. Now, at the conclusion of the Derivium audit, did you
15 issue a no-change letter, or recommend a no-change letter?

16 A. Yes.

17 Q. And from your recommendation, the area director sent out
18 the no-change letter, correct?

19 A. Correct.

20 Q. And does the no-change letter signify the conclusion of
21 the audit of Derivium?

22 A. Yes. We were done.

23 Q. That's all I'm asking.

24 A. Okay. Yes.

25 Q. And the no-change letter means you made no --

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1 MS. WEIS: Objection.

2 THE COURT: Sustained. Better rephrase that
3 question.

4 Q. Because the no-change letter was issued, there was no
5 change to Derivium's income?

6 A. Correct.

7 Q. Likewise, there was no change to its expenses?

8 A. Correct.

9 Q. And in fact, there was no penalties asserted at the
10 conclusion of the audit, correct?

11 A. That's right, for the type of -- generally, the penalties
12 that I -- well, that I recommend, I get my manager's
13 approval. There was no deficiency, there was no penalty.

14 Q. And during the course of the audit, did you ever
15 communicate to Mr. Nagy that he was engaging in conduct that
16 would be subject to a penalty?

17 MS. WEIS: Objection, Your Honor.

18 THE COURT: I'll sustain that because -- you need to
19 rephrase the question because you said, "he engaged in". So
20 I mean, with no allegation he engaged in any conduct in this
21 audit.

22 MR. COOPER: That's what I'm trying to establish.

23 THE COURT: Well, ask the question again.

24 Q. During the course of the audit, did you tell Mr. Nagy
25 that Derivium was promoting a tax shelter?

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1 A. No.

2 Q. During the course of the audit, did you tell Mr. Nagy
3 that he was promoting a tax shelter?

4 MS. WEIS: Objection, Your Honor, 403.

5 THE COURT: I'll sustain that objection. This is a
6 de novo hearing and that's what the jury issue is.

7 Q. Did you communicate to Mr. Nagy any concerns that
8 Derivium would be subject to promoter penalties?

9 MS. WEIS: Objection, Your Honor, per your motion in
10 limine.

11 THE COURT: Sustained.

12 MS. WEIS: Thank you.

13 MR. COOPER: I mean --

14 THE CLERK: What number is that?

15 THE COURT: You are going on to another issue?

16 MR. COOPER: Yeah, I mean --

17 THE COURT: Calm down, okay? We are getting ready
18 to take the morning break, because Amy is tired, and we'll
19 talk about what we talked about while the jury is relaxing,
20 how about that?

21 Ladies and gentlemen of the jury, you can go back to
22 your jury room and we'll be back in about 15 minutes.

23 (Thereupon, the jury retired from the courtroom.)

24 THE COURT: Okay. Do you want to state your
25 position with regard to that exhibit I admitted into

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1 evidence?

2 MS. WEIS: Yes, sir, Your Honor.

3 THE COURT: So I can make mistakes on both sides
4 when it goes to Richmond?

5 MS. WEIS: Your Honor admitted Nagy Exhibit 5, which
6 is Ms. Gadsden's notes that she took during interviews with
7 Mr. Nagy, and also an interview guide that she had.

8 Mr. Cooper failed to lay a foundation that those
9 documents were ever produced to Mr. Nagy. They reflect, we
10 would agree, some of the communications that Mr. Nagy made to
11 the IRS, but we feel that it also reflects her interpretation
12 of what those communications were, which was was not
13 communicated to Mr. Nagy; and therefore, should have been
14 excluded.

15 THE COURT: Okay. All right. I overruled that
16 objection.

17 How about the next one?

18 MR. CLUKEY: Yes, Your Honor. So exhibit, I believe
19 it's Mr. Nagy's 101, we object to that document being a
20 fraudulent document. Mr. Nagy testified in connection with
21 Exhibit 223, which is in evidence, that there was no
22 marketing administration agreement between Diversified Design
23 Associates and FSC as of 2000. This document purports to be
24 this 1998 document that was provided to the IRS in 2002. And
25 we believe it's a complete fabrication; and therefore, it

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1 would not meet any exception to the hearsay rule.

2 THE COURT: Well, that's totally within your
3 knowledge. And I said I would let it in and I would let you,
4 in reply, show that it's a fabrication, and then the jury can
5 consider anything it wants to consider, okay?

6 Now, you seem to be pained by something I have been
7 doing, so go ahead and tell me why you are pained, and
8 I'll --

9 MR. COOPER: I'm asking her what she communicated to
10 Mr. Nagy. And I asked her, did you communicate that Mr. Nagy
11 was promoting a tax shelter? I mean, I don't -- if that's
12 something that we talked about, about what's communicated
13 between the two, I don't understand why that's objectionable.

14 MS. WEIS: Because Mr. Cooper knows that it wasn't
15 communicated. And by asking the questions, he's implying
16 that there was information that was withheld that was not
17 communicated to Mr. Nagy and that the IRS engaged in
18 misconduct in that regard, which is what he's argued, and
19 Your Honor denied, or sustained our motion in limine, to
20 exclude that information.

21 MR. COOPER: But it's a fact. I mean, they are
22 drawing an inference with the fact; I'm just trying to
23 establish -- I have to bring it into evidence that what she
24 did and didn't communicate, and she issued a no change. Did
25 you communicate --

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1 THE COURT: Well, you have to bring in evidence what
2 she did communicate. That's the basis of the ruling. What
3 she didn't communicate, I've excluded, right? I mean, all
4 those notes and all that kind of stuff I excluded in the
5 motion in limine.

6 MS. WEIS: Mr. Nagy has also testified as to what
7 she did communicate. So we are not exactly sure what
8 additional evidence is being offered by having her testify
9 about what wasn't communicated.

10 MR. COOPER: It's from her side. Did you
11 communicate that? That's all I'm simply asking. And I don't
12 understand why the reaffirming what he testified is
13 objectionable.

14 THE COURT: You did a motion in limine, you argued
15 it. I said you could get anything in evidence that was
16 communicated to Mr. Nagy or that Mr. Nagy communicated to the
17 IRS. Something that was not communicated to Mr. Nagy, isn't
18 that within that motion in limine? I mean, I guess we could
19 go, you know, did you communicate to Mr. Nagy that there was
20 no income tax before 1922? I mean, you know, I assume that
21 would probably be something, too. There is lots of things
22 that aren't communicated. We are talking about your client's
23 state of mind.

24 MR. COOPER: Right.

25 THE COURT: And things that are not communicated to

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1 your client, how do they have any effect on his state of mind
2 back in, whatever this was?

3 MR. COOPER: Because he wouldn't believe anything
4 was wrong. He's now being assessed for conduct for allegedly
5 promoting a tax shelter. They did an audit at the time. And
6 all I'm trying to establish is, did you communicate that he
7 was involved in any penalty conduct?

8 MS. WEIS: He needs to first establish that was an
9 issue that he knew about.

10 THE COURT: An issue from her. I mean, there is no
11 testimony so far that she has anything to do with anything
12 with tax shelters or anything like that, is there? I mean,
13 that's why she referred, right?

14 MR. COOPER: That's right. But the lead agent is
15 the person who the information is supposed to be -- goes
16 through and who was --

17 THE COURT: Now we are getting back into IRS
18 internal stuff, which I've excluded one hundred thousand
19 times.

20 MR. COOPER: I'm caught between -- I can't get
21 behind the IRS to show what they do and what they consider,
22 and then objectively when I'm trying to show what was
23 communicated, I'm getting barred on it because I can't lay a
24 foundation because I can't go behind the veil.

25 THE COURT: I'm sorry. Do you want me to bend the

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1 Rules of Evidence so you can get something in that I don't
2 think you can get in?

3 MR. COOPER: But I don't believe it's bending the
4 Rules of Evidence.

5 THE COURT: Well, the problem is, the problem with
6 that retort is that your name was not on the door.

7 MR. COOPER: Yes, Your Honor.

8 THE COURT: Okay? That's my job.

9 MR. COOPER: Yes, Your Honor.

10 THE COURT: I do the best I can. You seem to think
11 I'm trying -- I'm here to screw your client. I mean,
12 that's --

13 MR. COOPER: Not at all.

14 THE COURT: -- I mean, that's -- so the subtext is
15 every time I make a ruling that is adverse, you give me this
16 wince, like I'm stabbing you with a pin on a voodoo doll.
17 I'm not trying to do that, okay? I just call them as I see
18 them, and I'm real sorry. I'm here to let evidence in that I
19 think is admissible. I'm in here to exclude evidence which I
20 don't think is admissible. I'm just doing the best I can,
21 okay?

22 And I've got -- and you've made great arguments on
23 some things and you won some, and you made great arguments on
24 other things and you lost some. I'm just doing the best I
25 can. And I'm sorry that you can't get things in you want to

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1 get in, but that's -- 100 percent of the time -- that happens
2 in every trial. And I may be wrong, I'm just doing the best
3 I can, okay?

4 MR. COOPER: Yes, Your Honor. I'm sorry. I
5 understand.

6 THE COURT: You are a wonderful, zealous advocate,
7 okay? And when the IRS comes against me, I'm going to hire
8 you, okay? All right. But hopefully, that will never
9 happen, all right?

10 MR. COOPER: Yes, Your Honor.

11 THE COURT: Although I filed an extension, I didn't
12 realize it was bad, okay, to file an extension, okay?

13 All right. Where else are we going? I mean, I
14 don't --

15 MR. COOPER: I am over halfway done.

16 THE COURT: Okay. Are there any other issues you
17 want to --

18 MR. COOPER: Well, the other issue that we brought
19 up was the -- in Exhibit Number 8, it was that page 6 that
20 they objected to.

21 THE COURT: Okay. Let's see it. Thank you.
22 Isn't this already in?

23 MR. COOPER: You did not let Exhibit 6 in.

24 MR. CLUKEY: Your Honor, that page does not appear
25 to be part of that document. It looks like it was never

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1 intended to be part of that. It looks like it was
2 inadvertently stuck in there.

3 THE COURT: Okay. Because it's got a U.S. Bates
4 stamp on it, I guess that came from the IRS files.

5 MR. CLUKEY: Whatever happened, if it got mixed up
6 in the files, we don't know what the problem is. Just
7 reading the context of the document clearly does not appear
8 to be part of it.

9 MR. COOPER: My understanding of the document is
10 that it is the actual approval of the lender to permit the
11 loan, and that's why it appears within the document. And
12 then below it is the subsequent assignment to the new one.

13 THE COURT: Let me take a look at it while we take a
14 break. We'll start again in about ten minutes, okay?

15 MR. COOPER: Can I ask one thing? And I will bring
16 this up for laying the foundation for this.

17 THE COURT: Oh, sure.

18 MR. COOPER: The Internal Revenue Manual, that is a
19 public document --

20 THE COURT: Right.

21 MR. COOPER: -- says that common penalties to be
22 considered are promoted dollars. And if I can lay the
23 foundation with her on the Internal Revenue Manual, may I
24 then ask her did she communicate that the -- whether --

25 THE COURT: If you ask her the question, did you

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1 consider promoter penalties, period, what would her answer
2 be?

3 MR. COOPER: It would be yes. That's why I can't do
4 that because you dropped the veil. So I have to lay the
5 foundation somehow. I will have to say, are these common
6 penalties that you are supposed to consider? Yes.

7 MS. WEIS: Your Honor, that is not what happened.
8 She never -- she was deposed in a full deposition last March
9 and she did not say that she considered promoter penalties as
10 part of the audit.

11 MR. COOPER: They referred the transaction to the
12 Office of Tax Shelter Analysis. They brought in a lawyer to
13 issue a John Doe summons on a promoter investigation.

14 MS. WEIS: We still don't understand how this is
15 getting around the motion in limine.

16 MR. COOPER: That's why I'm trying to be careful in
17 addressing it with you beforehand.

18 THE COURT: Let me see that, too.

19 MR. CLUKEY: Your Honor, this is -- it's feeding
20 into the argument that we provided to you with the witness on
21 Friday with those cases saying that taxpayers can't rely on
22 the Revenue Manual. But as a fundamental nature, by asking
23 about the Internal Revenue Manual, we are now getting into
24 what she was thinking and what was not communicated to her.

25 THE COURT: All right. I'll take a look at both of

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1 those.

2 All right. We'll start again at ten till.

3 (Thereupon, there was a brief recess.)

4 THE COURT: Correct me if I'm wrong, Mr. Cooper,
5 your client's defense is that he didn't have the state of
6 mind that would deserve a penalty being assessed by the IRS,
7 right?

8 MR. COOPER: That's correct, Your Honor.

9 THE COURT: And this is a de novo hearing that the
10 jury has to decide whether or not he had the state of mind in
11 order to have the IRS issue a 6700 penalty, right?

12 MR. COOPER: That's correct.

13 THE COURT: Okay. And is there any issue as to
14 whether or not, at this proceeding between your client and
15 the IRS, is not a legal and properly instituted civil
16 procedure under the Code of Civil Procedure, and the Internal
17 Revenue Code? I'm talking about this lawsuit. I mean --

18 MR. COOPER: That's correct.

19 THE COURT: They institute whatever they have to
20 institute and issue the 6700 penalties, and then your
21 recourse is to sue them in Federal Court?

22 MR. COOPER: That's correct.

23 THE COURT: So the procedure they went through in
24 order to force your client to sue them in Federal Court was
25 properly instituted under their --

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1 MR. COOPER: Yes.

2 THE COURT: I mean, and so -- and so since it's a de
3 novo proceeding, and it's properly instituted in Federal
4 Court, because you had to be in Federal Court, because they
5 assessed your client with 6700 penalties, what difference
6 does anything before that make as to your client's defense?
7 What difference does it make whether they brought this issue
8 up? What difference does it make that they went through all
9 this audit and the issue of the no-change letters and then
10 someone else decided to do a 6700 penalty? That's really
11 not -- and your client had no knowledge of that? What
12 defense is that to this lawsuit? I mean, I understand why
13 you don't like it, I understand you take offense at it and
14 you should be up front with me, but what defense is that in
15 this lawsuit?

16 MR. COOPER: Well, the defense is it goes to his
17 state of mind because the de novo proceeding is the
18 assessment of the 6700 penalty. What did the IRS consider to
19 make the assessment? What did they do behind the assessment?
20 This audit was not part of the 6700 assessment. This is a
21 separate fact.

22 So the de novo proceeding you have to have a
23 demarcation line. This audit is not the 6700 administrative
24 file that constitutes the de novo proceeding. This audit is
25 a process in facts that affected my client's state of mind

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1 and that might be some of the confusion, is how broad is that
2 de novo? The de novo goes behind what did they do in
3 determining that the assessment was valid, the 6700
4 assessment. This is an audit of Derivium. It's not had
5 anything to do with the 6700 assessment. So that's why it's
6 relevant.

7 MS. WEIS: Your Honor, he just said the audit had
8 nothing to do with the Section 6700 analysis.

9 Now, also he hasn't answered the question of, well,
10 if it wasn't communicated to Mr. Nagy, what bearing does that
11 have on Mr. Nagy's state of mind?

12 MR. CLUKEY: I would also add, Your Honor, this
13 interpretation of de novo, I'm not sure what Mr. Cooper is
14 getting at. We are not aware of any cases that say you only
15 look at one item, and de novo doesn't relate to anything else
16 in the history of the IRS. I'm not sure where that comes
17 from. If Mr. Cooper has some legal authority for that, I
18 would be anxious to see that.

19 MR. COOPER: Well, I think it gets back to what's
20 reasonable for him to believe. I mean, when we used to argue
21 this, the Justice Department, if someone goes and makes an
22 assessment for whatever it is, that the facts that the IRS
23 agent relied on in determining if the assessment was correct
24 or incorrect is what is behind that assessment.

25 And that's what the de novo proceeding protects.

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1 This was a whole different audit. It was totally different.
2 It happened five years beforehand. So the facts of the audit
3 go to his state of mind at the time he was giving this tax
4 advice. This audit was not the 6700 investigation, nor could
5 it be, because Mr. Nagy didn't get the 6700 letter until
6 2007, I believe.

7 THE COURT: Yes, sir?

8 MR. CLUKEY: We just reiterate what we just said,
9 Your Honor, not relevant. I didn't hear a case cite from Mr.
10 Cooper supporting that notion. And the information, as
11 you've already ruled with respect to the motion in limine, if
12 it was not communicated, it was not communicated, so how can
13 it have any bearing?

14 THE COURT: All right. Well, if I'm going to be
15 wrong, I might as well be wrong consistently, okay? I'll
16 sustain your objection as to this document. And as to the
17 Socks exhibit, I'll retain my ruling and say it's okay, okay?
18 So that's in.

19 This exhibit already in, except for this page?

20 MR. COOPER: Yes, Your Honor.

21 THE COURT: And what number exhibit is that?

22 MR. COOPER: Number 8.

23 THE CLERK: Number 8.

24 THE COURT: Okay. And there is no dispute that U.S.
25 0067 was given to one of the agents and maintained in the

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1 file?

2 MR. CLUKEY: Correct, Your Honor.

3 THE COURT: And your objection to 67 is, what, just
4 out of -- go ahead.

5 MR. CLUKEY: Our objection would be again a
6 document, part two. It's also --

7 THE COURT: I didn't understand. My hearing may be
8 going. I didn't understand what -- either part of what you
9 explanation was.

10 MR. CLUKEY: Sure. That it's a fabrication. That,
11 to be consistent with your prior ruling, you've let in
12 another document that we allege was fraudulent.

13 So then in connection with this, our main objection
14 would be it's simply not part of this document. It appears
15 from the face of the document it's not a piece of it.

16 THE COURT: And is -- is this -- I'm sorry,
17 Plaintiff's 8 is the -- did Mr. Nagy testify that he gave
18 this to the IRS or --

19 MR. COOPER: Did he testify to that?

20 THE COURT: Yeah. How did this get into evidence or
21 just by -- everybody agreed except for this page?

22 MR. COOPER: That's correct.

23 MR. CLUKEY: That's right.

24 THE COURT: And when this was discovered in the IRS
25 files, was it -- was it stapled together, for lack of a

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1 better term?

2 MR. CLUKEY: We have no idea how it was copied. It
3 could have been put in inadvertently to the file. We just
4 don't know.

5 THE COURT: And maybe in the Derivium files, is this
6 document found in the same form? You know, it looks like the
7 sample form, the John Q sample, or does anybody know?

8 MR. CLUKEY: Your Honor, we do have a John Q sample
9 document, and that page is not in that example that comes to
10 mind. We are not aware of it otherwise being, existing in
11 that same format.

12 MR. COOPER: I suppose that if the IRS has it, there
13 would have been no other way for them to get it except for --

14 MR. CLUKEY: Your Honor, if you look at the bottom
15 page of that document, every page is numbered, it's 1, 2, 3,
16 4, 5, and there is no page for that particular document.

17 THE COURT: And those notes on the top of each page,
18 Derivium 1069, 188, 12 are Gadsden?

19 MR. CLUKEY: We believe so, Your Honor.

20 MS. WEIS: She made those notations on every single
21 page, whether or not it was -- we understand that she made
22 that notation on every page, regardless of whether it was in
23 the same document or not.

24 So those notations are not unique to this particular
25 John Q sample. Mr. Cooper pulls up her activity record, for

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1 instance.

2 THE COURT: Does anybody know whether this page
3 is -- it seems to me like it's not part of this document,
4 especially the main thing is 1, 2, 3, 4, 5, then this page,
5 and then 6.

6 MR. COOPER: Um, my understanding is this is the
7 approval that would have been in like a John Q sample for the
8 loan to be done. This is a lender's agreement.

9 MR. CLUKEY: As we said, Your Honor, we are not
10 aware of that page existing in any of the John Q sample of
11 documents in this case.

12 MS. WEIS: Exhibit 38 contains a John Q sample and
13 it does not have that document.

14 THE COURT: How about the last page of the document?
15 What does that have to do with this document? It seems to be
16 a separate document, also.

17 MR. CLUKEY: We're not sure what that is, either,
18 Your Honor.

19 THE COURT: It's got the same date as the fax date
20 John Q.

21 Okay. Anything else, Mr. Cooper or Mr. Clukey?

22 MR. COOPER: No, Your Honor.

23 MR. CLUKEY: No, Your Honor.

24 THE COURT: I'll overrule your objection. I mean, I
25 don't -- I mean, I just don't have any facts to keep it out.

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1 It's in that form, the Bates stamp, it looks like it, for
2 what it's worth, and then you can argue that it's out of
3 context and all that.

4 So I'll admit whatever the DDA schedule that came
5 into evidence as part of Plaintiff's Exhibit Number 8. Okay.

6 Anything else?

7 (Thereupon, the jury returned to the courtroom.)

8 THE COURT: Okay. Mr. Cooper? Oh, do you want this
9 back?

10 THE CLERK: What number?

11 MR. COOPER: Exhibit 33.

12 Q. Ms. Gadsden, at the end of the Derivium exam, the IRS
13 issued Derivium a no-change letter, correct?

14 A. Correct.

15 Q. And Ms. Gadsden, are you aware that there are penalties
16 associated with -- for promoting tax shelters?

17 A. Yes.

18 Q. And in fact, with the approval of the territory manager
19 or the area director, you could recommend --

20 MS. WEIS: Objection, Your Honor.

21 THE COURT: Let him get the question out.

22 Q. You can recommend the assessment of tax shelter promoter
23 penalties?

24 MS. WEIS: Objection, Your Honor.

25 THE COURT: Overruled.

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1 THE WITNESS: I think I can, but there is a process
2 involved in doing it, and I truly don't know that much about
3 promoter penalties.

4 Q. But you can make the recommendation, right?

5 MS. WEIS: Objection, Your Honor.

6 THE COURT: Asked and answered. Sustained.

7 Q. Now, you also audited Mr. Scott Cathcart, correct?

8 A. I picked up the return of Scott and Whitney Cathcart
9 because they had not filed. So as part of the Derivium
10 audit, we looked at the partner returns because they are
11 partners in the partnership. So we considered the related
12 returns at the time of the Derivium audit. Not all of the
13 partners had filed their returns and Scott and Whitney
14 Cathcart had not filed the returns.

15 Q. So you obtained the returns from Mr. and Mrs. Cathcart,
16 correct?

17 A. Mr. Nagy was there as the representative.

18 Q. You obtained those returns?

19 A. Yes, the delinquent returns. And I really can't
20 recall -- I know it was more than one year, but -- I can't
21 recall which years they had not filed returns for, but those
22 returns were filed with the local -- I sent them to the
23 service center.

24 Q. And do you recall that you audited the Cathcart's 2000
25 return?

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1 A. Yes. That was one year that I secured their delinquent
2 return, yes.

3 Q. And I'm sorry to interrupt you.

4 A. Well, I secured their delinquent return.

5 Q. And for the 2000 return, do you recall if Scott Cathcart
6 did Derivium stock loan transactions?

7 A. I did not recall that until the deposition when you
8 showed me the return, that there was interest --

9 THE COURT: You are dropping your voice again.

10 THE WITNESS: I didn't recall that there was an
11 interest expense deduction on Scott and Whitney Cathcart's
12 return until I gave the deposition.

13 Q. All right. And during the deposition I showed you, this
14 was the 2000 tax return, correct?

15 A. Correct.

16 Q. And it has been previously introduced, and I'll hand you
17 a copy of the return.

18 A. Thank you.

19 Q. And do you recall this being the return that you audited?

20 A. I secured the loan, but I don't necessarily do a complete
21 audit, we just look it over to make sure that it appears to
22 be substantially correct. I did question -- there is losses
23 on line 17 from partnerships that flowed through his returns,
24 so I requested support for that.

25 And then as you showed me with the information

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1 document request, I requested support for the interest
2 expense deduction on the schedule.

3 Q. Right. And the interest expense deduction arose from the
4 Derivium stock loans?

5 A. And again, I didn't remember that until you showed that
6 to me.

7 Also, though, what I did remember is that I
8 requested K1's from the partnerships, and the partnership
9 returns that Scott or Whitney held in, I think it was
10 probably greater than 20 percent interest in, because the
11 biggest thing on the return are the partnership losses.

12 And actually, once I verified that those partnership
13 losses appeared to be correct, the information Mr. Nagy
14 provided, the Cathcarts had negative adjusted gross income,
15 they were already in the negative, they were in the hole.

16 So once that's -- the interest expense deduction is
17 further on the return as an itemized deduction.

18 So I really -- you know, once -- no matter what I
19 did with interest expense deduction, they had negative
20 taxable income. And if I disallowed that, it would have made
21 a negative, so it was smaller. It was not a real productive
22 use of resources for me or anybody else to really start
23 getting into the expense deduction, because there was -- he
24 was going to be -- have negative taxable income anyway.

25 Q. But first of all, looking at the partnership losses, you

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1 did allow those losses?

2 A. Based on what Mr. Nagy provided, the K1's that showed --
3 when you first look at the K1 about the partnership
4 information, that those get through loans that Scott Cathcart
5 could have been responsible for, partnership loans, they did
6 have basis to be able to take a partnership loss. You know,
7 that's really about all I did is looked over those K1's that
8 were provided to me.

9 Q. And because they had basis, those losses were
10 appropriate?

11 A. Correct.

12 Q. And back here is the 4952 with the investment interest
13 expense deduction?

14 A. Um-hum.

15 Q. And on the return --

16 THE COURT: For the record, would you say what
17 exhibit that is?

18 MR. COOPER: Exhibit 34.

19 THE COURT: 34?

20 MR. COOPER: Yes, sir.

21 Q. And then the attachment to the schedule showed that
22 \$150,036 was related to the Derivium stock loan, correct?

23 A. That's what this shows.

24 Q. And you were aware of this deduction being taken on the
25 return, correct?

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1 A. I must have been during the time, yes.

2 Again, I didn't remember it when I made -- if you
3 had asked me before the deposition, I did not recall.

4 Q. And I believe the reason you recall, it was Exhibit 31,
5 it's point number 4, you asked for the statements that showed
6 that interest deduction, correct?

7 A. I did request them.

8 Q. And Mr. Nagy provided them to you, didn't he?

9 A. To the best of my recollection, yes.

10 Q. So you were auditing that interest expense deduction,
11 correct?

12 A. Like I said, once I got past the partnership thing and
13 realized those partnership losses were deductible, he was
14 already in the negative. So to me, it became a nonissue.

15 Q. And the report and recommendation, which is Exhibit 37,
16 issued to Mr. Nagy --

17 A. Show the letter number down on the bottom right-hand
18 corner? Okay.

19 Q. Is this the cover letter to -- I think it's called -- I
20 get it confused, it's called a revenue agent report?

21 A. Correct.

22 Q. And attached to this letter, you sent a revenue agent
23 report?

24 A. Correct.

25 Q. And in your revenue agent report, you indicated that the

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1 return was subject to a no change request, correct, in the
2 first audit?

3 A. What does it say period ended there at the -- is this a
4 2000 no change report or the 1999 --

5 Q. Thank you. That was a good point.

6 If you go back farther, there is the 2000.

7 A. Right. And if you go down to line 3, you can see the
8 taxable income was a negative \$358,000.

9 Q. Right.

10 But if you disallow the investment interest expense
11 deduction, it would have reduced that loss, correct?

12 A. But it would have made the negative 350,000 negative
13 200,000.

14 Q. So it reduced it?

15 A. Right. The taxable income is zero.

16 Q. Right.

17 But don't taxpayers have loss carry forwards?

18 A. Some losses can be carried forward, um, most -- and I
19 don't have the words to go by by what the net operating
20 losses -- most schedule items do not create an operating
21 loss. The only thing I can think of quickly is a casualty
22 loss from a theft or something like that is generally the
23 only Schedule A item that will create an operating loss.

24 Q. You can carry forward the loss for a few years, correct?

25 A. The law has changed -- before you could carry -- it

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1 changes from years to years, we have to carry it back and
2 then carry it forward. And if you are going to elect not to
3 carry it back, you would have to make that election in the
4 loss year. And sometimes -- again, it changes. It changed
5 that period from year to year, then you have to -- you may
6 have to have made that election at the time you filed the
7 return, as well. So --

8 Q. So if you changed the loss, it could have had an impact
9 on the amount he could have carried back --

10 MS. WEIS: Objection, Your Honor.

11 Q. -- or carried forward?

12 THE COURT: Basis?

13 MS. WEIS: She's already testified that she doesn't
14 know the answer to these questions.

15 THE COURT: I don't think she said that, so I'll
16 overrule your objection.

17 THE WITNESS: I didn't understand.

18 Q. I'll go ahead and reask the question.

19 If you change the amount of loss, it could have
20 affected the amount of loss that could have been carried
21 back, or if the election was made, carried forward?

22 MS. WEIS: Objection, Your Honor, 602. Testimony of
23 law.

24 THE COURT: Overruled.

25 THE WITNESS: What I would say is there are -- this

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1 deduction was taken on Schedule A, itemized deductions.
2 Without looking at the Code, I don't know whether interest --
3 investment interest expense as a deduction could create a
4 loss that he can carry forward or back.

5 I do know for Schedule A items a casualty loss can
6 create a net operating loss.

7 Q. And in fact, do you know whether an investment interest
8 expense can be carried forward?

9 A. Investment interest expense can be carried forward.
10 Investment interest expense is only allowable up to the
11 amount of investment income, and generally that's why
12 taxpayers use that form that you just had up here, to use the
13 amount.

14 A. But are you talking about the carry forward to the
15 investment interest expense or are you talking about a net
16 operating loss?

17 Q. Just the carry forward -- if you would have disallowed
18 the \$150,036 as investment interest expense, Mr. and Mrs.
19 Cathcart could not have carried that forward.

20 A. Correct.

21 Q. So if there was a bunch of income in future years, that
22 loss could not be used to offset the investment income in
23 future years, right?

24 A. Well, let's look at this form, because on line 4-A is
25 their investment income, and it's \$168,000, right?

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1 Q. Yes, ma'am.

2 A. And their investment interest expense is 150. So they
3 had enough to be able to take it all in this year.

4 Q. Right.

5 So if you disallowed it, they would have paid more
6 tax in this year?

7 A. No, because they were already to the negative.

8 Q. It would have affected that negative number. You said it
9 would have been about 200,000?

10 A. Well, but you don't pay tax on negative taxable income.

11 Q. But it is a tax item that affects -- that could affect
12 income in future years, right?

13 A. No, because like the schedule that you just had up there,
14 he had enough investment income to be able to take that
15 expense in this year, and he did, he claimed it on the
16 return.

17 The only time investment interest expense gets
18 carried over is if you don't have adequate investment income.

19 Q. But if there wasn't adequate income, he could have
20 carried forward the loss in future years, correct?

21 MS. WEIS: Objection, Your Honor, asked and
22 answered.

23 THE COURT: Asked and answered.

24 Go ahead.

25 Q. The investment interest expense item was something you

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1 audited, though, correct?

2 A. I requested documents about it, but again, once the
3 partnership losses were allowable, it became a nonissue.

4 Q. Let me ask you this: When you do an audit, do you try to
5 get -- do you try to reach the most correct result you can?

6 A. We try to get to a substantially correct tax.

7 Q. And the Cathcart audit, you tried to get to the correct
8 result?

9 A. Again, this was a secured delinquent return in
10 relationship to a partner return, another entity. So really
11 what I was focused on was to try to get the taxpayer in
12 compliance with filing their returns.

13 Q. Well, do you know if Mr. Cathcart took the investment
14 interest expense deduction in 2001 and 2002?

15 A. I don't. If I did know at one time, I don't remember
16 now.

17 Q. Wouldn't it be, denying it on this report, the way of
18 telling Mr. Cathcart he wasn't entitled to that deduction?

19 MS. WEIS: Objection, Your Honor.

20 THE COURT: I'll sustain that. I mean, you've
21 already gone over it two or three times.

22 Q. Isn't a report recommendation, to your understanding, a
23 way to tell the taxpayer --

24 MS. WEIS: Objection, Your Honor.

25 Q. -- whether he's --

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1 THE COURT: Ms. Weis, you are a lot smarter than I
2 am, you probably know what the question is going to be, but
3 I'm real slow. Let him get the question out and then you
4 object and then I'll rule, okay?

5 Go ahead.

6 Q. Is it your understanding that the report recommendation
7 is a way to let the taxpayer know whether or not tax items
8 are being recorded correctly?

9 MS. WEIS: Objection, Your Honor.

10 THE COURT: Overruled.

11 THE WITNESS: You give the taxpayer a report, it
12 tells them the things that we looked at, changes that we make
13 on their return, and generally whether we are accepting the
14 return or changing the return.

15 Q. So is the answer yes, it tells a taxpayer that they're
16 reporting items correctly?

17 MS. WEIS: Objection.

18 THE COURT: Overruled.

19 THE WITNESS: It all depends on what kind of
20 reporting you are saying. Sometimes there is a report that
21 gives them a refund, sometimes there is a report that they
22 owe money, and sometimes it's a no change report. We can't
23 audit every line item on every return. So, yes.

24 Q. But you ask for information on the investment interest
25 expense, right?

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1 A. Correct. I did ask for information.

2 Q. And in fact, do you remember sitting in Mr. Nagy's office
3 and specifically discussing the original interest discount
4 rules as applicable to the investment interest expense?

5 A. The interest discount rule?

6 Q. The original interest discount rules?

7 A. No. Is it in my notes? You are talking about OID,
8 original issued --

9 Q. Yes. Do you recall sitting in Mr. Nagy's office and
10 having a conversation about whether those rules applied to
11 Mr. Cathcart's investment interest expense?

12 A. No, I don't.

13 Q. And again, the no change report that is issued at the end
14 of the Cathcarts' audit, that report indicated the conclusion
15 of the audit, correct?

16 A. Correct.

17 Q. And Exhibit 37, which is your report and recommendation,
18 that indicated the conclusion of your review of the returns,
19 correct?

20 A. Correct.

21 Q. And was it your understanding when you issued the no
22 change report for Scott Cathcart that you communicated to Mr.
23 Nagy that the Derivium stock loans were bona fide?

24 MS. WEIS: Objection.

25 THE COURT: Sustained. Rephrase that question.

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1 Q. When you issued the no change reports in 2000 on Mr. and
2 Mrs. Cathcart's return, is it your understanding you
3 communicated to Mr. Nagy that you accepted the stock loans as
4 a bona fide loan?

5 MS. WEIS: Objection.

6 THE COURT: Basis?

7 MS. WEIS: Rephrasing the previous question. He was
8 asking for her understanding of what the no change meant and
9 communicated.

10 THE COURT: Overruled.

11 THE WITNESS: Could you say the question for me?

12 MR. COOPER: I'll do my best. I may elicit another.

13 THE COURT: Do you want me to read it for you?

14 MR. COOPER: Read it for me?

15 THE COURT: I have it right here.

16 MR. COOPER: Oh, really?

17 THE COURT: Magic, isn't it?

18 All right. The question is: "When you issued the
19 no change reports in 2000 on Mr. and Mrs. Cathcart's return,
20 is it your understanding you communicated to Mr. Nagy that
21 you accepted the stock loans as a bona fide loan?"

22 MS. WEIS: I don't mean to object to your question.

23 THE COURT: If you did object to it, I would
24 overrule it, okay?

25 Now, do you remember?

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1 THE WITNESS: No.

2 Q. Do you recall when I took your deposition on
3 March 27th --

4 A. I remember that.

5 Q. And on March 27th, 2009, and you were sworn to tell the
6 truth.

7 Do you recall that?

8 A. Um-hum.

9 Q. And do you recall me asking you questions about what the
10 no-change letter communicated to Mr. Nagy?

11 A. I reread the deposition. I really don't. That was truly
12 not a very fun experience for me, so I'm sorry if I don't
13 remember.

14 MR. COOPER: Your Honor, I would like to have her
15 read in page 174, lines 3 through 10.

16 MS. WEIS: Your Honor, we would object. We don't
17 believe that that is actually --

18 THE COURT: That's why I give them the deposition.

19 Okay. Why don't you read your question and she can
20 read her answer, okay?

21 Q. "Question. So there was a no change. So didn't you
22 have, that time you issued a no-change letter, it was
23 communicated that it was a bona fide loan for which an
24 interest expense could be taken?"

25 A. Correct. And I said at that time it was accepted as a

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1 bona fide loan.

2 Q. From the time you issued the no-change letter to Mr.
3 Cathcart in June of 2003 until January of 2009, did anyone at
4 the IRS contact you about the examination?

5 MS. WEIS: Objection, Your Honor, relevance and
6 motion in limine.

7 THE COURT: What was the second part?

8 MS. WEIS: Motion in limine.

9 THE COURT: I'll sustain that. I think it's subject
10 to the motion in limine.

11 MR. COOPER: Your Honor, I would like to move in
12 Exhibit Number 76 under 801(d)(2) as a party admission.

13 MS. WEIS: Your Honor --

14 MR. COOPER: Nagy Exhibit 76. Look at question B in
15 the definition on the third page.

16 THE COURT: I'll sustain the objection to that right
17 now and we can argue about it at lunchtime.

18 MR. COOPER: Thank you, Your Honor.

19 Your Honor, after I ask about that document, I'll
20 have five minutes of conclusion and I'll be done.

21 THE COURT: Okay. So if I sustain the objection to
22 that conclusion, that means you are done?

23 MR. COOPER: Well, I will conclude, but I would like
24 to be able to talk to you about Exhibit 76.

25 THE COURT: All right. Okay. So -- all right.

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1 We'll go to lunch right now and we'll start again at 2:00.

2 Ladies and gentlemen, enjoy your lunch and we'll
3 start again at 2:00.

4 (Thereupon, the jury retired from the courtroom.)

5 THE COURT: Ms. Gadsden, you are off the hook right
6 now. We'll see you at 2:00.

7 Yeah?

8 MR. COOPER: I would like to introduce it as a --
9 under 801.

10 MS. WEIS: Your Honor, if he's trying to introduce a
11 court-ordered interrogatory from the California injunction
12 action about whether or not the IRS and the IRS agents made
13 any determinations that this was a -- the 90% Loan Program
14 was a taxable loan, Ms. Gadsden repeatedly testified she did
15 not make that determination.

16 We also have the financial product specialist who
17 said that she also never made that determination. So
18 while -- and we have the last question which we will be
19 intending to offer when Ms. Gadsden is questioned on
20 cross-examination when she was asked: "Did you actually make
21 a determination of the loan Scott Cathcart was engaging in,
22 the 90% loan -- did you actually make a determination that
23 the loans that Scott Cathcart was engaging in, the 90% loans
24 that he was engaging in, that those were bona fide? Did you
25 make that affirmative determination?"

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1 "I really don't recall," is her response to that
2 question. And at another time she says she didn't think that
3 she did.

4 So we don't understand the relevance of offering in
5 a consistent statement of the Government, where Ms. Gadsden
6 or no IRS agent has made that determination in the first
7 place.

8 MR. COOPER: She just communicated she accepted it
9 as a loan.

10 And in fact, if you go to page 3, when you look at
11 the Government's own definition of determination, Ms. Gadsden
12 testified that the report, Exhibit 37, was the conclusion of
13 her audit.

14 She also testified the no-change letter was the
15 final conclusion of the audit, which fits within the
16 definitions that the Government set forth in the definition
17 of determination.

18 Therefore, this is an inconsistent statement, as
19 well as an admission.

20 And B, that there was a determination of a bona fide
21 loan in accordance with the Government's definition of the
22 document.

23 MR. CLUKEY: Your Honor?

24 THE COURT: Yeah.

25 MR. CLUKEY: This Court has already issued jury

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1 instructions about what a no-change letter means. And Mr.
2 Cooper is trying ever so desperately to get behind that and
3 thinks that he's on the precipice here to be able to do that
4 with the testimony of Ms. Gadsden. Ms. Gadsden did not
5 testify that she ever made a determination. Repeatedly
6 throughout her deposition, she says she wasn't qualified to
7 make that determination. So that's 601, 602. She says it
8 repeatedly.

9 Mr. Cooper just asked her on the stand if she --
10 about this hedging and sale, purchase loans, transactions,
11 she referred that to other people, she did not make a
12 determination that this was a valid loan and that she was
13 consistent with that. So any statement, consistent statement
14 from California litigation, how that could have any possible
15 bearing --

16 MR. COOPER: Your Honor, I can hand up her
17 deposition and I can lay it with her, 172, 10 through 173, 2,
18 that she says that you can only take investment interest
19 expense if it's a bona fide loan. So I could get that out.

20 And secondly, it's not your jury instruction, this
21 is the Government's definition in this document, and that's
22 all I'm trying to establish.

23 MS. WEIS: Your Honor, if we could direct your
24 attention to the financial products specialist reports, since
25 Ms. Gadsden said she didn't have any expertise to make this

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1 determination, the report of the financial products
2 specialist states -- it's exhibit -- Nagy Exhibit 28, page 4:
3 "Conclusion. Issue: Loan versus sale is not being
4 pursued any further because international examiner's
5 conclusion was that the taxpayer was not considered a
6 permanent United States establishment of a foreign entity.
7 The potential adjustment under the issue would be considered
8 and would have no United States impact. No adjustment
9 required."

10 Eventually the financial products specialist who was
11 the person to ask to looking at this issue reached a
12 determination on the loan versus sale question.

13 MR. COOPER: Your Honor, this is Scott Cathcart's
14 examination and what Ms. Gadsden did during that examination.

15 If you read her deposition, she testified you can't
16 allow the investment interest expense unless it's a bona fide
17 loan. We just read into the record where she accepted it as
18 a bona fide loan.

19 From this interrogatory, I can demonstrate that the
20 answer to here is not right, and under the Government's own
21 determination that it was a legitimate bona fide transaction.

22 THE COURT: Okay.

23 MR. CLUKEY: Your Honor, we would add that to
24 backdoor this in, Mr. Cooper's trying to get in IRS's agents
25 to testify about the meaning of the law under *Teague* and

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1 under *Adelman*, both Fourth Circuit decisions, people cannot
2 testify about what's the role of the Court.

3 Here you have a nonattorney that Mr. Cooper has
4 asked questions about the meaning of the law. So to backdoor
5 some kind of determination here, he's having her attempt to
6 have her testify about the law. And this information was
7 never communicated to Mr. Nagy. I mean, this is all wrapped
8 up in the motion in limine that has been decided, and Mr.
9 Cooper is attempting to circumvent that.

10 THE COURT: All right. I'll think about it and I'll
11 let y'all know.

12 Anything else we need to deal with? It looks like
13 to me that we'll probably argue the charge tomorrow. I don't
14 know how long it's going to take your redirect examination of
15 this, and then reading in -- how long is the reading of the
16 deposition going to take?

17 MR. COOPER: I think it's only 35 pages.

18 THE COURT: All right.

19 MR. CLUKEY: We don't expect the redirect will take
20 very long.

21 THE COURT: We'll cross that bridge when we come to
22 it. Y'all have the jury charge now, so you are ready to go.

23 I mean, I'll -- I'll be -- if y'all want to go for
24 it, it's fine with me. I'll take a look at this and we'll be
25 back.

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1 We'll see you about five minutes until 2, okay?

2 Thanks.

3 (Thereupon, there was a lunch recess.)

4 THE COURT: Okay. Any other additions or
5 corrections on the final charge?

6 MR. CLUKEY: We have a number.

7 THE COURT: Pardon?

8 MR. CLUKEY: Yes, Your Honor, we have a number of
9 objections we would like to discuss.

10 THE COURT: On the charge?

11 MR. CLUKEY: Yes.

12 MS. WEIS: Based on what was added from Mr. Nagy's
13 suggestions.

14 THE COURT: Oh boy. Okay. All right. So how about
15 you?

16 MR. COOPER: I profess I didn't have the time to
17 look at it.

18 THE COURT: It looks like more and more we'll be
19 going tomorrow morning then. I've got to discuss it with you
20 and make copies of them and all that. I thought I gave you
21 everything you wanted.

22 MR. CLUKEY: We are happy with everything you gave
23 us, it's some additions that came from Mr. Nagy that we got
24 at 5 PM last night.

25 THE COURT: So did I. And there is three of yours.

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1 MR. CLUKEY: You provided us --

2 THE COURT: All right. How about as to Plaintiff's
3 Exhibit 76? Do you have any other objections you want to put
4 on the record?

5 MS. WEIS: I guess, Your Honor, this is the
6 court-ordered interrogatory; is that correct?

7 THE COURT: Yeah.

8 MS. WEIS: A clarification? We understood that Your
9 Honor was not going to allow evidence on what was not
10 communicated to Mr. Nagy. So starting from that point, we
11 don't understand why Mr. Cooper is attempting to offer
12 Exhibit 76 --

13 THE COURT: Okay.

14 MR. COOPER: -- for two reasons:

15 One: That in accordance with their definition of
16 determination was made.

17 And two, for impeachment purposes.

18 MS. WEIS: Well, Ms. Gadsden wasn't making a
19 statement, so he can't impeach her.

20 And two, it still doesn't answer the question that
21 why information that was not communicated to Mr. Nagy is
22 trying to be admitted into evidence.

23 MR. COOPER: I guess I'm using it through Ms.
24 Gadsden because that's the witness I have. But it's a
25 statement by the Government. It's an authorized statement by

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1 their agent.

2 And you remember Judge Carr, well, he -- you upheld
3 his ruling. They told me I couldn't take a deposition. And
4 part of the basis was they gave you written responses to
5 written discovery and you can use that at trial. So this is
6 what I'm stuck with.

7 THE COURT: Okay.

8 MR. CLUKEY: Your Honor, we would like to add some
9 additional context to Ms. Gadsden -- to the answer that was
10 read into the record. The way that we -- the way that we
11 read that final couple sentences that were read in, it was
12 not impeachment. Ms. Gadsden had not said that anything was
13 communicated to Mr. Nagy. She had simply said that at the
14 time the IRS had accepted, so internally had accepted a bona
15 fide loan. So there is a whole lot of context -- in fact,
16 the prior pages to that places this whole discussion in
17 context.

18 And if I can give you two cites.

19 THE COURT: Sure.

20 MR. CLUKEY: Page 142, line 6, through 144, line 9.
21 And then later on in the deposition, which precedes what Mr.
22 Cooper read, which was 171, line 14, through 174, 10.

23 And just to summarize this, Your Honor, Ms. Gadsden
24 was asked in the context of the interest deduction what the
25 IRS was doing and she said, look, this has been referred over

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1 to, to see whether this was actually a tax shelter. There
2 hadn't been any determination about whether there is a sale
3 versus a loan. I didn't have the expertise to make that
4 determination.

5 And so then Mr. Cooper follows up, what about this
6 \$150,000? That's what this whole context is laid out. She
7 says we had not made the determination, I didn't know whether
8 this was a valid loan or not. That's the point. And there
9 is an explanation here. It is simply no changed because they
10 didn't want to keep the audit open, and that's what the first
11 cite relates to, sort of customer service reasons.

12 They were auditing it because of Derivium, the
13 partner got swept in, there had been a year and a half and
14 there had been no change, all of that context is critical to
15 the answer that was taken out of context that some
16 determination was made that's clearly not communicated in any
17 form to Mr. Nagy.

18 THE COURT: Okay.

19 Yes, sir? Anything?

20 MR. COOPER: I'm happy for what was --

21 THE COURT: I'll sustain your objection to 76.

22 And so the total upshot of what she testified here
23 today is that once she looked at the -- at Mr. Cathcart's
24 returns and she found that the \$150,000 is irrelevant, then
25 she didn't make any determination at all, okay?

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1 So what's -- what's next? Okay. Are you just going
2 to finish your examination of her examination?

3 MR. COOPER: Yes, sir.

4 THE COURT: Okay. All right. Bring the jury in.
5 (Thereupon, the jury returned to the courtroom.)

6 THE COURT: Okay. Mr. Cooper?

7 Q. Ms. Gadsden, because the audit of Derivium entailed you
8 as the agent, a financial product specialist, and then an
9 international examination, would you consider the audit to
10 have been thorough?

11 A. Of Derivium?

12 Q. Yes, ma'am.

13 A. Yes.

14 Q. And in fact, audits that entail financial product
15 specialists, international examiners of a governing agent,
16 they happen seldom?

17 A. At that time, yes. Um, we are actually using more and
18 more referrals. So I guess in my experience at that time
19 that was unusual.

20 Q. And as an employee and an agent of the Internal Revenue
21 Service, do you try to provide good customer service to
22 taxpayers?

23 A. I try.

24 Q. And is part of that customer service effective
25 communication with the taxpayers?

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1 MS. WEIS: Objection, Your Honor.

2 THE COURT: Overruled.

3 THE WITNESS: Yes.

4 Q. And during your communications with Mr. Nagy -- and I
5 believe you testified to this beforehand -- but from your
6 interactions with Mr. Nagy throughout the course of the
7 audit, you were under the impression that Mr. Nagy believed
8 this was a legitimate transaction --

9 MS. WEIS: Objection, Your Honor.

10 Q. -- a legitimate loan transaction?

11 MS. WEIS: Objection.

12 THE COURT: Basis?

13 MS. WEIS: 602. Asking for her understanding of his
14 belief.

15 THE COURT: Overruled.

16 THE WITNESS: So you are asking me if during this
17 audit I felt that Mr. Nagy believed this was a valid
18 transaction?

19 MR. COOPER: Yes.

20 Q. From your interaction with him and your impression you
21 got from him.

22 A. Yes.

23 Q. Now, we talked at the beginning that this transaction,
24 during the initial interview, Mr. Nagy told you that Derivium
25 administered it nationwide.

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1 Do you recall that?

2 A. Um, I believe my notes said they operated nationwide.

3 Q. Yes, ma'am.

4 Do you recall that?

5 A. Yes.

6 Q. And Mr. Nagy told you that it was Derivium's position
7 that the stock loan transaction was a loan and not a sale for
8 tax purposes, right?

9 A. Yes.

10 Q. And you were auditing Derivium, correct?

11 A. I was auditing Derivium's income and expenses, yes.

12 Q. And you were auditing Scott Cathcart, correct?

13 A. I said he was found to be not in filing compliance. And
14 as part of that audit of Derivium, I picked up his -- secured
15 his billing and returns and inspected them for accuracy and
16 questioned a few items on them.

17 Q. But you're auditing Scott Cathcart for the 2000 tax year?

18 A. Yes, but it really was more a result of Derivium rather
19 than just a regular audit of Scott Cathcart's return.

20 Q. And you knew Scott Cathcart did Derivium's stock loan
21 transactions because you audited his return, right?

22 A. From looking at this return, again, I must have, because
23 it's on their interest related to stock loans on that return.

24 Q. Right.

25 In fact, Mr. Nagy provided you with specific

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1 information about that?

2 A. And it's on here. And then he provided me the interest
3 statements, I believe, or the total interest, accrued
4 interest as of what was deducted on the return.

5 Q. Now, when you issued the no-change letter to Scott
6 Cathcart, did you consider what that the acceptance of Scott
7 Cathcart's loan transactions at the time would have had on
8 Derivium's future conduct?

9 MS. WEIS: Objection, Your Honor, 402, motion in
10 limine.

11 THE COURT: I'll sustain the objection to that
12 question as being indecipherable because I'm reading it and I
13 don't understand it.

14 So if you want to rephrase it, go ahead.

15 Q. When you issued a no-change letter to Scott and Whitney
16 Cathcart in 2000, did you consider the implications of the
17 no-change letter or what it would have on Derivium's future
18 conduct?

19 MS. WEIS: Same objection, Your Honor, 402 and
20 motion in limine.

21 THE COURT: I'll overrule the objection.

22 THE WITNESS: No.

23 MR. COOPER: That's all I have.

24 CROSS-EXAMINATION

25 BY MS. WEIS:

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1 Q. Good afternoon, Ms. Gadsden.

2 Now, Mr. Cooper asked you some questions about the
3 Derivium audit and I want to talk a little bit about that
4 today.

5 When you were talking with Mr. Nagy about the lender
6 that was involved in the 90% Loan Program, he told you that
7 there was a real lender; is that correct?

8 A. Yes.

9 Q. It was a real lender that was independent from Derivium?

10 A. Correct.

11 Q. Now, Mr. Nagy also told you, I think we saw in your
12 notes, that that that lender had a brokerage account and
13 Derivium managed the brokerage account for the lender; is
14 that correct?

15 A. Yes.

16 Q. And he told you that the lender's name was on the
17 brokerage account; is that correct? You can look at your
18 notes.

19 A. Yes.

20 Q. Okay.

21 A. I don't have a copy of them.

22 MS. WEIS: Can you pull up N-05, page 6?

23 THE WITNESS: It says: "Broker account. Taxpayers
24 management control over this for the lender."

25 Q. Okay. Here. I'll hand you up a hard copy.

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1 So your notes say that stock was transferred to the
2 broker account of lender that is managed by Derivium?

3 A. Correct.

4 Q. And this is what Mr. Nagy told you was happening in 1998;
5 is that correct?

6 A. Correct.

7 Q. And your audit was looking at the 1998 tax year. So any
8 questions you had were about 1998?

9 A. Yes.

10 Q. And he told you the lender's name was on the brokerage
11 account?

12 A. Yes.

13 Q. Now, are you aware that last week Mr. Nagy testified that
14 in 1998 Derivium's name was on the brokerage account that was
15 used?

16 A. No. Well, no.

17 Q. All right. Now, Mr. Nagy also told you, I believe your
18 notes reflect if you look down on the page, Exhibit 5, page
19 6, it says: "Lender is not required to issue 1099s as it is
20 foreign."

21 Is that what he told you? Mr. Cooper asked you some
22 questions about that.

23 A. Yes.

24 Q. So Mr. Nagy, he told you again that there was a real
25 lender involved, and that they weren't issuing 1099s because

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1 it was a foreign lender --

2 A. Correct.

3 Q. -- right?

4 Now, when you met with Mr. Nagy, he also told you
5 that the lender was independent from Derivium; is that
6 correct?

7 A. Yes.

8 MS. WEIS: Can we pull up Exhibit 221? Government
9 Exhibit 221? Pull up the top portion.

10 Q. So now Mr. Nagy testified last week, these are his
11 handwritten notes: "DDA new ownership, 8-4, 2000. Charles,
12 Scott, Yuri, percentages."

13 Did Mr. Nagy show you this document when you met
14 with him in 2002?

15 A. No.

16 Q. Now, Mr. Cooper asked you about your impressions of how
17 cooperative Mr. Nagy was at the time that you met with him
18 during the audit.

19 Do you recall that?

20 A. Yes.

21 Q. At the time I think you said you thought that he
22 looked -- appeared cooperative to you?

23 A. That's correct.

24 Q. Knowing now that some information wasn't given to you,
25 would you still describe him as being cooperative with you

1 during the audit?

2 A. No, because it seems like he told me what he wanted me to
3 know.

4 MS. WEIS: No more questions.

5 MR. COOPER: Nothing further.

6 THE COURT: Thank you, ma'am. Okay.

7 MR. COOPER: We call Mary Socks by deposition
8 testimony.

9 THE COURT: Okay. All right. So we are now going
10 to have the deposition of Mary Socks like we had before.

11 MR. COOPER: She might play a little bit better than
12 Dr. Cathcart.

13 THE COURT: How about just, let's explain the
14 deposition. Tell the jury who Mary Socks is. I don't know
15 whether it's in the deposition or not. I think she's the --

16 MR. COOPER: She's the financial products specialist
17 that was brought into the exam.

18 THE COURT: Okay. Good. Thank you.

19 (Thereupon, the deposition testimony of Mary Socks
20 was read to the jury.)

21 MS. WEIS: Your Honor, I think these last couple of
22 pages we went through are counter designations.

23 THE COURT: You mean there is some more that should
24 have been read?

25 MS. WEIS: No, that we had -- I don't know how much

1 you want me to get into it now, but there had been some
2 cutting down on the testimony and some counter designations,
3 and I thought we moved through this sort of to keep it short.

4 THE COURT: All right. Based on what you just told
5 me, where should it start again?

6 MS. WEIS: I think actually that was it.

7 MR. COOPER: That's it.

8 THE COURT: That's it? Okay. All right. Good.

9 MR. COOPER: We rest our case.

10 THE COURT: Okay. Reply?

11 MR. CLUKEY: No reply, Your Honor.

12 THE COURT: Okay. Ladies and gentlemen of the jury,
13 why don't you go back to the jury room now, because we've got
14 to talk about the jury charge. And I'll be back in about ten
15 minutes to see whether we can go forward today or if it's
16 better to give us more time to go over the jury charge,
17 because I've got to make copies of it. And I've already done
18 it three times, but I've got to do it again for each one of
19 you. We may go forward today or first thing tomorrow
20 morning.

21 So give me about ten minutes and I'll talk to the
22 lawyers and we'll go from there, okay? Either way, you will
23 have it done tomorrow.

24 (Thereupon, the jury retired from the courtroom.)

25 THE COURT: Okay. All right. Mr. Clukey, you've

1 got -- anywhere you need some additions or corrections or
2 objections to the jury charge?

3 MR. CLUKEY: Yes, Your Honor. The first one is on
4 page 6.

5 THE COURT: Page 6? Okay. So there was an addition
6 by Mr. Cooper, the second paragraph of page 6.

7 THE COURT: Uh-huh.

8 MR. CLUKEY: "In deciding whether or not to believe
9 a witness, keep in mind that sometimes people forget things."
10 In addition --

11 THE COURT: I can read it. I understand, all right?
12 What's your objection?

13 MR. CLUKEY: To substantial -- really right here,
14 that's an issue for the jury, whether they consider that to
15 be substantial time or not. A period of time may have
16 transpired since their witness prepared or reviewed a
17 document, that's fine, it's really the adjective
18 "substantial," we object to that.

19 THE COURT: Okay.

20 All right. What's the next one? All right. You
21 can argue substantial. I'll take that out.

22 MR. CLUKEY: Your Honor, the next one would be on
23 page 12.

24 THE COURT: All right.

25 MR. CLUKEY: So the bottom paragraph there on the

1 page.

2 THE COURT: Wait a minute. I just remembered
3 that -- now Mr. Cooper hadn't had time to go over it, so I
4 don't know -- at lunchtime, I remember. I think that's what
5 you said, right?

6 MR. COOPER: Yes, Your Honor, but I'm keeping up
7 right now.

8 THE COURT: Okay. That's fine. I just didn't want
9 to -- if you needed some time to go over it, and we can do it
10 in half an hour, 45 minutes, I don't care, tell me what you
11 want.

12 MR. COOPER: I'm fine right now.

13 THE COURT: So if you feel unfine, let me know and
14 we'll give you whatever time you need.

15 MR. COOPER: Thank you.

16 THE COURT: Okay. Page 4.

17 MR. CLUKEY: The bottom paragraph there, an
18 additional factor is the clarity of the law, the time the
19 advice was given, and then the rest of that.

20 Your Honor, we believe this all relates to a couple
21 criminal cases that Mr. Cooper cited, and those criminal
22 cases, there is a vastly different standard that's in place
23 for willfulness in a criminal case.

24 This Court ruled that the transaction violated
25 substance over form. That doctrine had been around since the

1 1940s. And many cases of the Supreme Court have cited
2 substance over form over the years. It's not like this area
3 of the law was unclear about substance over form.

4 So we believe that this -- this portion of the
5 instructions should be removed.

6 THE COURT: Okay. So you wanted to remove the last
7 paragraph on page 12 and the first two lines on page 13?

8 MR. CLUKEY: Correct, Your Honor.

9 THE COURT: Okay. I'll think about that.

10 All right. What's next?

11 MR. CLUKEY: And, Your Honor, also, we discussed the
12 cases that Mr. Cooper cited. And I could actually hand that
13 up to you, it's in our --

14 MS. WEIS: Our opposition to his motion for summary
15 judgment. He cited the same cases and made a similar
16 argument.

17 MR. CLUKEY: Yeah. You denied that motion for
18 summary judgment. That's Docket Number 75.

19 THE COURT: Okay.

20 MR. CLUKEY: That's on pages 14 to 15 primarily this
21 issue is discussed.

22 THE COURT: You are talking about the issue --

23 MR. CLUKEY: We are just talking about the section
24 we wanted to strike.

25 THE COURT: Docket number, what?

1 MR. CLUKEY: 75.

2 THE COURT: Okay.

3 MR. CLUKEY: And pages 14, 15 -- I can actually give
4 you these two pages if you would like, Your Honor.

5 THE COURT: That's good.

6 MR. COOPER: With that regard, I would just point
7 out you denied summary judgment. That doesn't mean the law
8 is wrong; that just means it was material issues of fact as
9 to what may or may not influence his state of mind.

10 THE COURT: All right. What's next?

11 MR. CLUKEY: Your Honor, that might be it. I recall
12 that there was one more item, but I don't have anything else
13 written down.

14 THE COURT: Okay. Well, maybe since it's importantt
15 and I need to do research, why don't I bring the jury back
16 in, let them go, we'll start first thing in the morning. How
17 does that sound, Mr. Cooper? That will give you some time to
18 go over it and react to what they just told me. We can argue
19 about it later this afternoon, and we'll have everything done
20 and start first thing in the morning.

21 Is that okay with you?

22 MR. COOPER: Absolutely.

23 THE COURT: Is that okay with you?

24 MR. CLUKEY: Yes, Your Honor.

25 THE COURT: Okay.

1 (Thereupon, the jury returned to the courtroom.)

2 THE COURT: Okay, ladies and gentlemen. I think
3 it's -- based on what we have to do here this afternoon with
4 regard to the jury charge, and make copies of everything,
5 every time I try to make copies, my government-issued copy
6 machine breaks.

7 So it's probably a better use of your time to let
8 you go and we'll start again with the argument and the charge
9 first thing tomorrow morning at 9:30.

10 Don't discuss the case among yourselves, don't
11 discuss -- you've heard all the evidence in this case,
12 tomorrow you will hear the final arguments of the lawyers and
13 my final charge of the law, which I'll give you each copies
14 of, and then you will be able to deliberate and decide this
15 case.

16 But rather than have you sit there in the jury room
17 and mess around, we'll let you mess around at home or
18 wherever you are, okay? So we'll see y'all at 9:30 in the
19 morning.

20 (Thereupon, the jury retired from the courtroom.)

21 THE COURT: Okay. So why don't we be at ease until
22 3:30, or if you are ready before that, I'll be upstairs and
23 I'll come on down. I'll go over -- I'll take a look at what
24 you've given me and what your complaints are.

25 Mr. Cooper, if you find anything, just e-mail Frank,

1 or whatever, and I'll take a look upstairs and we'll decide
2 the whole thing. I think Frank has already e-mailed each of
3 you the verdict form, that's not rocket science.

4 So take a look at that. If y'all agree on it, if
5 that's okay, and we'll go ahead and make those.

6 So we'll be at ease until 3:30. Okay. Great.
7 Thanks.

8 (Thereupon, there was a brief recess.)

9 THE COURT: Okay. Did y'all find anything else?

10 MR. CLUKEY: Yes, Your Honor. I sent Frank an
11 e-mail. We wanted to renew our motion, which we presume was
12 implicitly denied under Rule 50. We are just raising it on
13 the same grounds --

14 THE COURT: Okay.

15 MR. CLUKEY: -- for judgment in favor of the United
16 States.

17 We also wanted to, on 50 with the issue of
18 materiality, the reason why we believe materiality has
19 already been established, the case law explains materiality,
20 that material matters are those which would have a
21 substantial impact on the decision making process of a
22 reasonably prudent investor and would include matters
23 relevant to the availability of tax benefits.

24 And this Court found when we filed for summary
25 judgment one great benefit to the customer if he participated

1 in the program is favorable tax treatment because the
2 transactions were marketed as loans by Derivium.

3 Your Honor, no contradictory evidence is in the
4 record indicating that the statements made by Mr. Nagy were
5 not material. We don't believe that that is an issue, that
6 there is any evidence upon which the jury could conclude that
7 the statements were not material.

8 THE COURT: Okay. When I read Document 75, after
9 you cited it to me in there, part of the Summary Judgment
10 Motion you said Mr. Nagy does not dispute materiality. I
11 don't know whether that --

12 MS. WEIS: I think that was for summary judgment.

13 THE COURT: Okay. What you say, Mr. Cooper?

14 MR. COOPER: Well, as to materiality, I think Mr.
15 Polk also said that customers relied on diversification,
16 possibly estate planning. So I don't think tax purposes was
17 established as the only reason for doing this transaction.

18 THE COURT: Well, certainly that is a subset of tax,
19 at least until this year. So I think if I wanted to die, I
20 would die this year so I could preserve the estate; is that
21 right?

22 MR. COOPER: I believe there is a variety of
23 reasons. With respect to each transaction, you know, I would
24 think that they had the burden under the Statute to prove
25 whether it was material, each transaction was, to try and

1 promote the penalty. I think there is a dispute in the
2 record about why individuals did this.

3 Specifically, if you look at the economics of it,
4 you excluded it. That in fact, if you take the 90 percent
5 loan and then pay capital gains three years down the road,
6 you end up with less than you would have if you would have
7 just sold it on day one.

8 So the very implication of the economics of the
9 transaction is there would be reasons besides the tax
10 benefits. And I think Mr. Polk actually testified very
11 clearly that it was for diversification purposes with the
12 ability to participate in upside. I don't believe that had
13 any implication to tax.

14 THE COURT: Okay.

15 MR. CLUKEY: Your Honor, we would add that this law
16 doesn't require it be the only reason, it merely has to have
17 a substantial impact on the decision making process, that's
18 what the law requires, not it's the only reason.

19 Secondly, Congress specifically eliminated taxpayer
20 reliance as an element of the offense. So no matter what Mr.
21 Polk said, even if for some reason the Court was to think
22 that it had to be the only reason, it doesn't matter what the
23 customer found, it's the reasonable prudence standard,
24 whether that had a substantial impact on that person.

25 And we believe all the evidence in the record shows,

1 as this Court found previously, that there was a great
2 benefit to the customer in this transaction being tax
3 deferred.

4 THE COURT: Okay. Anything else, Mr. Cooper?

5 MR. COOPER: No, Your Honor.

6 THE COURT: All right. What else? Anything else?

7 MR. CLUKEY: That's it, Your Honor. And then any
8 ruling you would have on materiality would impact, obviously,
9 the jury instructions in a couple pages in there.

10 THE COURT: All right. How about, is there any
11 other additions or corrections that you found, Mr. Cooper?

12 MR. COOPER: With regard to the jury instructions?

13 THE COURT: Yes, sir.

14 MR. COOPER: Yes, Your Honor. I would like to focus
15 on page 11.

16 THE COURT: Uh-huh.

17 MR. COOPER: And in the first full paragraph, and
18 it's the third sentence that starts, "A person directly makes
19 or furnishes."

20 THE COURT: Um-hum.

21 MR. COOPER: The examples in the following sentence,
22 "Authors or edits documents containing false statements that
23 others will distribute to potential customers." That example
24 is the finding of fact on if you made any corrections to
25 documents. And I think that the jury should be able to

1 decide whether or not he caused directly or indirectly for
2 that to be sent out.

3 I believe, one, we don't know, for instance, if the
4 versions of the documents he corrected were even sent out.

5 Number two, whether or not he had ultimate say.

6 I think all the folks from Derivium testified, as
7 well as Mr. Nagy, that he didn't have ultimate say on what
8 went out and what form went out.

9 So by giving this direction, I believe it
10 established that you are directing the jury as to a fact,
11 which I believe is in dispute in this trial, on whether he
12 caused, directly or indirectly through his actions of editing
13 things.

14 So I would request that that last sentence be taken
15 out and allow the jury to deliberate on that fact, instead of
16 instructing them to it.

17 MR. CLUKEY: Your Honor, those factors are both
18 mentioned in the *Estate Preservation Services* case, the Ninth
19 Circuit leading case on this on 6700, as well as *Alexander*,
20 which is a District of South Carolina case, where tax packets
21 were distributed to members and the group's owner made or
22 caused statements to be made regardless of whether he
23 actually authored the materials. There is two cases that we
24 cited in connection with that. We don't believe that the
25 jury is making a finding here by including this.

1 THE COURT: You mean the Court?

2 MR. CLUKEY: I'm sorry. That the Court is making a
3 finding by including this in here. These are simply factors
4 recognized by courts as being -- as being relevant to
5 answering the question of whether this has been furnished or
6 not.

7 THE COURT: Okay. Anything else, Mr. Cooper?

8 MR. COOPER: In that same paragraph, and you made
9 the insertion on the previous page, that the second sentence
10 we say, "this court has already ruled," I just ask again, for
11 clarity, you just insert in December of 2009 for that. And
12 then --

13 MR. CLUKEY: Your Honor, we would object to that
14 insertion.

15 THE COURT: Why? It's true.

16 MR. CLUKEY: It is true.

17 THE COURT: You mean you don't want me to give the
18 jury the truth?

19 MR. CLUKEY: Of course we want the jury to have the
20 truth, Your Honor, the whole truth.

21 I guess we would -- at that point we might ask for
22 an instruction clarifying the substance over form doctrine
23 has been around since the 1940's, and that could accompany
24 that 2009 ruling. I would be perfectly comfortable with
25 that.

1 THE COURT: Okay. What makes it more egregious
2 included on page 11 than having it included on page 10 since
3 there wasn't any objection to doing it on page 10?

4 MR. CLUKEY: It's no more egregious, Your Honor. I
5 just missed that.

6 THE COURT: Okay. Well, if you miss it, it must not
7 have been very important when you read it. I think I'll
8 overrule your objection to his inclusion. I'll put it in.

9 MR. COOPER: The last line on page 11.

10 THE COURT: Uh-huh.

11 MR. COOPER: Where it says "statements made or
12 omitted," the use of "omitted" the statute says specifically
13 "a statement with respect" -- and it doesn't include the word
14 "omitted". So I would ask that it be removed.

15 MR. CLUKEY: Your Honor, this is pertaining to
16 scienter, it's not that. So it's obviously statements made
17 or omitted clearly pertain to scienter. So that's -- that's
18 simply not an accurate reflection of Mr. Cooper's making two
19 different portions of the Statute, two different elements.

20 THE COURT: Okay.

21 MR. CLUKEY: So this is just a statement, you are
22 talking about actual knowledge, and you can't prove that.
23 This is just standard charging.

24 THE COURT: Because really, the Statute at page 9
25 and 10 I say -- it says it over and over and over again.

1 MR. COOPER: Okay. I thought that was consistent.
2 I didn't understand why the omitted language was put in after
3 you used the word statement.

4 THE COURT: It's kind of circumstantial evidence
5 charge. So I'll leave that in there, okay?

6 MR. COOPER: On page 13, the first full paragraph,
7 the last sentence that starts with "additionally," from there
8 down, this charge about the disclaimers, um, I don't know, I
9 sort of dug around -- I don't understand the legal basis of
10 saying that the disclaimer as a matter of fact, and that's
11 just my --

12 MR. CLUKEY: Your Honor, in connection with our
13 proposed jury instruction there, we provided the Court with
14 citations of three different cases, one of which is the
15 District of South Carolina case. The case is *Alexander*, the
16 citation is 2010 WL --

17 THE COURT: 1643425.

18 MR. CLUKEY: We believe it was also cited in *Schulz*,
19 which is a 2007 case from the District of New York, and then
20 *Kukhahn*, it's a 2008 case from the Western District of
21 Washington.

22 MR. CLUKEY: The other thing, Your Honor, Mr. Cooper
23 put those disclaimers clearly at issue with numerous
24 witnesses, so we believe it's a very important instruction
25 clarification for the jury.

1 MR. COOPER: I just didn't know, in the context -- I
2 looked for it in the context of 6700 cases and didn't see it,
3 so I didn't know why that could not be -- I just didn't know
4 about the application of the law to a 6700 case. But the
5 instruction is, I perceive, is relatively strong on the
6 issue. And I didn't -- I guess I lacked an understanding as
7 to the basis for it.

8 THE COURT: The *Alexander* case, which is the one
9 from three months ago from Ross Anderson, is a 6700 case, and
10 that's where that language came from.

11 Although it's been my rule just to quote Ross, but
12 follow Joe, and this one I'll follow Ross -- we have two
13 federal Andersons, Ross Anderson and there is Joe Anderson,
14 for those people who don't know, okay.

15 So I'll overrule your objection as to that on page
16 13.

17 MR. COOPER: And the last one is to take up the
18 issue on page 14 with the no-change letters.

19 THE COURT: Uh-huh.

20 MR. COOPER: What I submitted to Mr. Ulmer, I cited
21 law as to being able to rely on no changes as to having a
22 reasonable basis or a reason that you weren't engaged in
23 conduct subject to penalty, because those cases found that
24 audit determinations were a defense to penalties.

25 And I tried to clarify that in my proposed language

1 and none of it was accepted. And I went back and tried to
2 redraft it, you know, where it would be more acceptable or
3 something like, "While Mr. Nagy cannot rely on the no-change
4 letters as binding determinations as to validity or correct
5 tax treatment of the 90% Stock Loan, he is entitled to rely
6 on the no-change letters in support of what he believed at
7 the time." Something to that effect.

8 Because I believe your comments in the trial was
9 they are not determinations, but they may go to what he
10 believed at the time, and something consistent with that,
11 instead of just saying they are not determinations, because I
12 believe there is something about determinations for tax and
13 defenses to penalties and that's why I have been trying to
14 craft some kind of language that would be consistent.

15 THE COURT: Yes, sir?

16 MR. CLUKEY: Your Honor, Mr. Nagy testified about
17 what he thought the no-change letter meant.

18 You warned Mr. Cooper at the beginning of trial that
19 you were going to define what a no change was, the definition
20 of a no change is; however, Mr. Nagy cannot rely on the legal
21 determinations by the IRS. Mr. Cooper knew that was going to
22 be the case going in the trial.

23 And so since Mr. Nagy was allowed to testify about
24 what his interpretation and view of it was, we are not sure
25 why another instruction should go in here, and I'm not

1 exactly entirely sure what Mr. Cooper wants the instruction
2 to read.

3 THE COURT: Actually, what he wants me to tell them
4 is that because he got a no-change letter, it's a complete
5 defense and he ought to walk out of the courtroom, and that's
6 what he wants.

7 Would that be a fair summary?

8 MR. COOPER: Um --

9 THE COURT: Just being a little flip, but...

10 MR. COOPER: A wink and a nod. Yes, absolutely.

11 THE COURT: Okay.

12 MR. COOPER: But you can -- actually, you can leave
13 the sentence exactly like it is and just add a sentence
14 saying, while it is not a determination, you can consider it
15 as to Nagy's state of mind at the time, or you may consider
16 whether it could have had an impact on Nagy's state of mind
17 at the time.

18 And I think that is consistent with the comments
19 you've made to me.

20 THE COURT: Because the three cases that you rely on
21 are individual taxpayer cases, they are not 6700 cases, and
22 there is no reasonable cause defense in 6700 like there were
23 in the *Gilmore* and *Stewart* cases.

24 MR. COOPER: Right. That's definitely right, Your
25 Honor.

1 But I will say if you look at the regulations for
2 the reasonable cause defense, which is under the Internal
3 Revenue Code, there is two defenses, and there is two prongs
4 to it, Your Honor.

5 The first is there has to be substantial authority
6 for the transaction. That's one part of the reasonable cause
7 defense, or you have a reasonable basis for the transaction,
8 and a good faith belief as to that position. And if you read
9 those cases, they talk about the good faith belief, which is
10 a state of mind. So again, we are dealing with 6700. There
11 is not a lot of case law. There isn't a reasonable cause.

12 But in the same vein, Section 6700 does have an
13 intent or belief aspect to it, just like that second prong of
14 reasonable cause.

15 So it's the best law we've got, and we used it under
16 those circumstances to show that that taxpayer had a good
17 faith belief. And that's why we are trying to use it here.
18 And I think Your Honor has agreed with that, saying even
19 though it may not be a tax determination, it may have had
20 some impact on Mr. Nagy's belief.

21 MR. CLUKEY: Your Honor, I believe the instruction,
22 if you just go up the instruction a little bit further, it's
23 already implicit in the instruction itself, that they could
24 take this no-change letter into consideration. It says, "you
25 should consider this" -- talking about the no change -- "you

1 should consider this evidence in determining whether or not
2 the Government has met its burden of proving that Mr. Nagy
3 knew or had reason to know statements regarding the 90% loan
4 transactions were false or fraudulent."

5 It goes on additionally with you further expanding
6 on that. We just think the instruction is pretty clear as
7 written. To go so far beyond that would be basically to
8 undercut the last sentence in the instruction.

9 MR. COOPER: I don't think it would undercut it if
10 you craft it to the effect of while it's not a tax
11 determination or legally binding, you may consider it as to
12 Nagy's belief.

13 THE COURT: Isn't that what it says in the sentence
14 before, though?

15 MR. COOPER: It doesn't. He said implicitly, I
16 would agree with that. It was sort of like, what's the
17 implicit of Ms. Gadsden not saying something? I mean, it's
18 better to say it and define it correctly instead of having
19 the jury draw the incorrect conclusion upon it.

20 We would just ask that that's what the case law
21 supports and I think Your Honor has said that.

22 THE COURT: Okay. Maybe this will be better, all
23 right, in that paragraph, "You have heard evidence regarding
24 no-change letters that the IRS sent to the various
25 people/entities associated with the 90% Loan Program." I'm

1 using the last sentence as the next sentence. "Mr. Nagy
2 cannot rely on the no-change letters as binding
3 determinations made by the IRS or legal determinations made
4 by the IRS, but you should consider this evidence in
5 determining whether the Government has met its burden of
6 proving Mr. Nagy knew or had reason to know that certain
7 statements are false or fraudulent."

8 So I'm just rearranging that paragraph, which is
9 essentially what you want.

10 MR. COOPER: Yes, Your Honor. That is helpful.
11 Thank you.

12 THE COURT: I'll just flip that, okay?

13 MR. CLUKEY: That's fine.

14 THE COURT: Okay. All right. I'm not going to
15 excise those two examples, I think they are from case law.
16 The first one may or may not apply to Mr. Nagy, the second
17 one certainly doesn't apply to Mr. Nagy, it's just another
18 example. So you can argue those, and they say they are
19 examples, they are not findings.

20 Okay. Anything else, Mr. Cooper?

21 MR. COOPER: No, Your Honor, that's all I have.

22 THE COURT: Okay. How about -- anything else, Mr.
23 Clukey?

24 MR. CLUKEY: Just the -- I presume you are going to
25 tell us, just the items that we raised concerning the

1 instructions.

2 THE COURT: On the bottom of page 12, top of page
3 13.

4 MR. CLUKEY: Yes, that's one of them.

5 THE COURT: Okay. What was the other one?

6 MR. CLUKEY: The stipulation. The substantial -- I
7 can't remember, did you actually strike the word substantial?

8 THE COURT: Yeah.

9 MR. CLUKEY: Okay. Thank you. And then obviously
10 material, materiality, whether --

11 THE COURT: Okay. It seems to me that I'm going to
12 take out the bottom of page 12 and the top of page 13,
13 because the law in this area is not unclear whatsoever. The
14 law in this area is that if it's a sale, you pay taxes on it,
15 and if it's a loan, you don't. That's the law.

16 Now, the facts in this case may be foggy or
17 indeterminate or unclear, but the law certainly isn't
18 unclear.

19 MR. COOPER: I would agree as to the ultimate issue,
20 if it's a sale, you pay tax; if it's a loan, you don't.

21 THE COURT: And that's the law.

22 MR. COOPER: I would agree with that, but the
23 analysis on whether it's a sale or a loan --

24 THE COURT: That's fact based, isn't it?

25 MR. COOPER: Pardon?

1 THE COURT: Isn't that fact based?

2 MR. COOPER: It's legal based, too. I went through
3 1058, 1036, 1239, the revenue rulings, and there was no cases
4 or IRS directive on point until Judge Hamilton ruled in
5 California in December of '09.

6 So it's like a legal argument, or my opinion -- I
7 take a position, I look for the law, I make the best argument
8 I can, and that's my opinion, and it's grounded in certain
9 statutes, case law, revenue rulings. So ultimately, you are
10 right. If you get to the opinion, the tax applications fall
11 out, but it's that process of getting to that conclusion for
12 which there was no law.

13 THE COURT: There was law. I mean, being very
14 unsophisticated, if it's a sale, there is tax; if it's not a
15 sale, if it's a loan, there's no tax, right? That's where we
16 start and end. That's where we end, right?

17 MR. COOPER: That's where you end.

18 THE COURT: But to get there, isn't everything else
19 fact based?

20 MR. COOPER: No. But you remember when we briefed
21 this and they raised their motion for summary judgment, and
22 they said it was a sale, and I argued before Your Honor that
23 it was a loan, and I brought up the *Welch* test, the *Grodts*
24 test, I argued Revenue Ruling 2003-7, I argued *Odend'hal*, I
25 argued *Bees Ferry Associates*, all those cases that set forth

1 parties' intention, the value of the collateral is more than
2 the value of the loan, and all of those factors supported our
3 position.

4 At that time, you know, that I attempted to make
5 that argument before you, that was the legal basis for my
6 conclusion it was a loan. I was making that argument
7 grounded in case law and revenue rulings, no different than
8 what Mr. Nagy was doing when he was giving his opinions to
9 his client.

10 And that's why if there is no case law directly on
11 point that impacts your state of mind, and I think the *U.S.*
12 *vs. Weir* case in the Northern District of Alabama said
13 specifically, the Mid-South scheme may have been almost too
14 good to be true, but it had a semi-logical basis in the tax
15 laws which permitted, even encouraged schemes not unlike this
16 one.

17 The Court went on to say, "never actually realize,
18 nor he had reason to believe in 1982 and 1983 that what he
19 was representing to the 34 customers by way of purportedly
20 favored tax consequences wasn't false and that's because the
21 Court didn't rule until 1985 on that issue."

22 So it's the same analysis the Court went through in
23 *U.S. vs. Weir*, that if there was no direct case law on point,
24 but if I had a semi-logical basis in law to make the argument
25 and Mr. Nagy had a semi-logical basis in law, that that went

1 to his intent at the time on whether he believed that advice
2 was false.

3 MR. CLUKEY: Your Honor, Mr. Cooper just referenced
4 a whole bunch of sale versus loan cases. So a whole bunch of
5 sale versus loan cases that existed has been around for a
6 very long time. And anybody can go look at these cases and
7 find out factors that determine whether it's a sale versus a
8 loan. It's not complicated. He just referenced the *Weir*
9 case. The *Weir* case involved Mid-South Music.

10 Mid-South Music was found prior to the decision in
11 *Weir*, was enjoined as a tax shelter. Penalties were imposed
12 and the core promoters were penalized. The person in *Weir*
13 was a subpromoter who was duped by the -- by the main
14 promoters. And he relied on the opinion of lawyers he had.
15 He had opinions.

16 And so it was a very fact-based analysis, it wasn't
17 as a legal matter. The area of the law was unclear; and
18 therefore, he couldn't be held that -- there needed to be
19 some kind of explanation or he couldn't be held liable, is
20 absolutely not the case. And actually, it's referenced in
21 the *Estate Preservation* case. So it's a very factually
22 determinative case.

23 So one, there is a lot of case law out there on sale
24 versus loan.

25 Second, this Court also said it violated substance

1 over form.

2 So again, a second reason that it was out there.
3 And Mr. Nagy testified he knew about substance over form in
4 '97. So there are two things that are absolutely clear at
5 the time he was rendering all his decisions.

6 MR. COOPER: I think the case that makes the point
7 here is the McDermott Will & Emery position in 2001, they
8 went through the same analysis as Mr. Nagy to get to the end.
9 It was the analysis that mattered. They looked at the same
10 statutes, they looked at the same type of case law. It was
11 the analysis.

12 I mean, there was no case law on point. McDermott
13 Will & Emery said that -- they also said that there is no
14 form over substance cases related to nonrecourse loans.
15 Instead, they looked at the *Estate of Franklin* case that says
16 that if the value of the collateral is more than the loan,
17 the transaction has economic substance. They wrote that in
18 their opinion. Mr. Nagy did the same analysis in Exhibit 41.

19 So it is the analysis under the law. I would agree
20 that after you ruled in December of '09, anyone that does one
21 of these transactions knows it, but before then, no tax court
22 had ruled.

23 In fact, we briefed a tax court case in early '08 in
24 the *Commissioner vs. Shao*, or *Shao vs. Commissioner*, the
25 Judge has yet to rule on it. So if a tax court hasn't ruled

1 on it in two years, there must be some semi-logical basis, or
2 even a substantial basis for going through the analysis and
3 coming to a conclusion that differs with the IRS.

4 So that's what we want the jury to understand is if
5 there was no direct on point and there is unclarity in the
6 law, that that goes to his state of mind in doing the
7 analysis.

8 MR. CLUKEY: Your Honor, just because somebody
9 creates a new transaction that hasn't been done before
10 doesn't mean the state of the law is unclear. That's a
11 ridiculous proposition. They created something called a 90%
12 Stock Loan. If it's called something else, they simply
13 changed the name. So the Court hasn't ruled on that. You
14 change the security involved. When the core issue is sale
15 versus loan, the core issue is substance over form, those two
16 issues just -- I mean, it's -- it's -- frankly, it's hard to
17 understand.

18 And then when you try to pair it with this
19 instruction that Mr. Cooper would have, he's now assuming
20 that the state of the law is unclear. And when the law is
21 vague or highly debatable, a person is less likely to know or
22 have reason to know that a position of law taken by the
23 person is false, I mean, that comes straight out of criminal
24 cases where there is a very high standard. In tax criminal
25 cases, it is a very different standard than the standard

1 under 6700.

2 MR. COOPER: The Fourth Circuit case, the *Critzer*
3 case, it relied on the Second Circuit case, I'm going to
4 butcher the name, it's *Kahr vs. Commissioner*, it's 414 F2d
5 621.

6 So the Fourth Circuit in a criminal case looked to a
7 civil case against the IRS in the Second Circuit coming to
8 the principle, and he said it exactly right, when it's
9 debatable and it's unclear, you lack intent, and that's all
10 the proposition is for.

11 And I don't understand this proposition that -- the
12 Fourth Circuit in the *Odend'hal* case that we briefed to you,
13 Your Honor, they drew a bright line rule. They said if the
14 value of the collateral is more than the nonrecourse loan,
15 there is an economic incentive to pay it off at the inception
16 of the transaction, and that's what you look at for economic
17 substance. And that's what McDermott Will & Emery analyzed
18 in the *Estate of Franklin* case in the supplemental
19 memorandum, and that's the exact same analysis my client did.

20 So if that's the law and that's economic substance,
21 and there is no direction from the IRS saying 90% stock loans
22 are a tax shelter, they never issued that. So if he had a
23 basis in the law for saying it's a loan, and they had that
24 economic intent.

25 THE COURT: Okay. All right. I'll think about it

1 and I'll -- we'll e-mail you another copy of the charge, all
2 right?

3 Anybody have any problem with the verdict forms?

4 MR. CLUKEY: No, Your Honor.

5 THE COURT: Okay. Anybody have any problem with any
6 other part of the charge that we haven't addressed? Okay.

7 All right. I'll e-mail you a final copy of the
8 charge and we'll go from there. And so if there is anything,
9 we'll see y'all at 9:00 tomorrow morning. The jury is coming
10 back at 9:30.

11 You may want to stay here and make sure all the
12 exhibits are in evidence, so we can do that now rather than
13 have the jury wait for them.

14 If there is anything that comes up that you think of
15 between now and tomorrow morning, e-mail Frank and let him
16 know. Once I give you copies of the charge, then I'm going
17 to make copies for the jurors, so they will have them here
18 and you can know tonight when you are replanning your closing
19 arguments, you can refer to the same pages the jury will
20 have. And I think it helps the lawyers and that helps the
21 jurors out for sure, because I've done cases and they
22 underline them and all that kind of stuff.

23 So we'll let you know, all right? Anything else?

24 MR. CLUKEY: Yes, Your Honor. What is the jury
25 going to be told, if anything, about the second phase of the

1 trial? Are they going to be told anything about that?

2 THE COURT: Not until the first phase is over.

3 And the second phase of the trial, from what I
4 understand, is Mr. Cooper goes first, you are going to call
5 Mr. Nagy, assuming we get that far, you are not going to call
6 anybody, and then we are going to have a short argument, I
7 guess, as to the amount.

8 And then like I said, Mr. Cooper goes first, you go
9 second and he has a rebuttal, okay? I don't know what he's
10 going to put in, but besides Mr. Nagy, is there anybody else
11 that you are going to call in the second phase, assuming we
12 get that far?

13 MR. COOPER: No, sir.

14 THE COURT: And everybody agrees, I assume, that if
15 the verdict is in Mr. Nagy's favor in the first half, we
16 don't have to go to the second half, do we?

17 MR. CLUKEY: Correct, Your Honor.

18 THE COURT: Okay. Thanks.

19 And 78 is the -- the Altemose report, that's the one
20 that we are making Court's Exhibit 1, right?

21 MR. COOPER: Yes, sir.

22 THE COURT: There. It's right there.

23 THE COURT: Thank you.

24 (Thereupon, the Court was in recess.)

25 * * *

I certify that the foregoing is a correct transcript from the
record of proceedings in the above-titled matter.

Amy C. Diaz, RPR, CRR

February 17, 2011

S/ Amy Diaz

Court's Exhibit Number 1	940
MS. NEVA GADSDEN	945
DIRECT EXAMINATION	945
BY MR. COOPER	
Plaintiff's Exhibit Number 5	959
Plaintiff's Exhibit Number 101	971